The New York Certified Public Accountant

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AN ADIRONDACK VIEW

Accounting Stories that are really good, are few and far between. Other professions have many—for example, the doctors and lawyers. The accounting profession will too, as it gets older. The best one "in my opinion" landed recently.

A man had been the accountant for a large wholesale company for forty-five years. It had grown from a small one-man company to a good, big corporation. It advertised extensively—"where our customers send their friends."

Every morning he was the first one there. Every morning he unlocked the middle drawer of his desk, looked in, then closed and locked it. This habit was noticed by others and, over the years, a great curiosity grew. What was in that drawer?

As it must to all men, death came to our faithful friend. After a respectful few days, the drawer was opened. The office staff attended in a body. The keys had come from the widow, the right key was found, the key was turned, the drawer was pulled open. Inside was a large, white card; on it was printed in big letters, the following:

"The column toward the window is the DEBIT column."

LEONARD HOUGHTON
"Adirondack Chapter,
Saranac Lake Branch"

HAVE YOU GOTTEN AT LEAST ONE NEW MEMBER FOR THE SOCIETY?

Book Reviews

Corporate Reorganizations—Their Federal Tax Status (Second Edition)

By Robert S. Holzman. THE RONALD PRESS COMPANY, New York, N. Y., 1955. Pages: xix + 487; $15.00.

"Corporate Reorganizations?" said the C.P.A., wearily pushing aside his workpapers, "that's for those specialists who work with the big corporations." "Not so," suggests Professor Holzman, at least with respect to that part of the statement limiting reorganizations to large corporations. The opportunities of tax postponement inherent in reorganizations are available to, and should be considered by, all corporations large or small. Undoubtedly, the carrying out of the actual work requires a specialist's skill, but one of the objectives of this book is to set forth clearly the steps in the reorganization process so that the non-specialist can appreciate their tax significance.

This second edition of what has become a standard work on the tax status of corporate reorganizations includes the many changes brought about by the Revenue Act of 1954. The author has retained his lucid method of organizing the material and presents the law and regulations surrounding this field in as clear-cut a manner as the subject permits. The book is designed for all those who have anything to do with corporate reorganizations whether as accountant, lawyer, corporate officer, or other employee charged with the responsibility. Indeed, since the main beneficiaries of a tax-free reorganization are the stockholders, it might well be argued that even investors would benefit from more familiarity with this field.

This book can be used readily by people with different levels of tax experience. The highly qualified tax specialist will find a convenient collection of all the statutes, regulations, rulings and cases, completely indexed and cross referenced, as well as helpful comments on various aspects of the subject. The newcomer to the field can quickly obtain a broad overview of the subject and an understandable explanation of the problems to be faced.

The author appears to be uniquely equipped for the preparing of a commentary of this type because he has broad practical training—he was head of the tax department of a major corporation that was involved in numerous substantial reorganizations and has participated in many large and small reorganizations — and an ability to analyze clearly the complicated situations involved, gained through his many years of teaching of the subject. Dr. Holzman is the first full-time Professor of Taxation at the New

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Book Reviews

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York University, Graduate School of Business Administration and his work there with tax practitioners interested in reorganizations has undoubtedly been of help to him in assembling the material for this book.

The main contribution of the second edition, of course, is to give detailed attention to the new features set forth in the 1954 Code. In his preface, the author summarizes these changes as follows:

> " . . . modified treatment of stock dividends, redemption of stock to pay death taxes, complete liquidation of subsidiary companies, treatment of stock rights, *pro rata* distribution of stock in a controlled company, basis of property contributed to a corporation, subsequent reacquisition of redeemed shares, complete liquidation within one calendar month, receipt of new securities in exchange for old, assumption of liabilities, and numerous other topics. The book discusses the new tests for partial liquidations, distributions of appreciated-value property, and distributions essentially equivalent to the distribution of a taxable dividend, and shows how previous court decisions are affected by the new tax law. New technical terms are carefully defined."

This quotation shows clearly that the book covers other areas than would be encompassed in the strict use of the word "reorganization." Indeed, this book might more exactly bear the same title as Subchapter C of the 1954 Revenue Act—"Corporate Distributions and Adjustments." Like Subchapter C, a large part of this book is devoted to distributions by corporations and corporate liquidations including a discussion of the collapsible corporation. Obviously, these problems are part of the reorganization picture even though they have independent applications to non-reorganization matters. The discussion of these matters is thorough and extremely well documented. Extensive quotations from the 1954 Code precede the discussion of each topic. The rules under the old law are summarized, the indicated changes are explained, and sometimes illustrated from the new regulations which were in their proposed form when this book went to press. (A revised printing is planned for February and the book will have 50-odd examples from the final regulations.)

Following the discussions of corporate liquidations, the author proceeds to the reorganization problem itself. In some 45 pages he deals with transfers to a controlled corporation, exchanges of stock and securities in certain reorganizations, and the distribution of stock and securities of a controlled corporation. He likewise discusses ad-

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BUSINESS AND PERSONNEL OPPORTUNITIES

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Book Reviews

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ditional consideration that may be received in certain distributions, assumption of liability in connection with receipt of property, and the basis to the distributee of property received. Then follow chapters on insolvency reorganizations and carryovers. At this point the author departs from the five part arrangement contained in Subchapter C of the 1954 Code which has served him as an overall guide during the first two-thirds of the book.

In the latter third of the book the many concepts of reorganization developed by the courts are set forth in chapters entitled: Recapitalizations, form versus substance, formalities and elections, sundry considerations, and synthesis. This is probably the most stimulating part of the book. One notes particularly the reexamination of the *Gregory* case and the conclusion that, despite recent judicial questioning, it is now even stronger than ever since the Senate Finance Committee struck out the clause "literal compliance with all the provisions upon which the statute conditions non-recognition of gain or loss shall be sufficient to achieve the results there set forth" from the Conference Committee Report.

In addition to its broad coverage of the field, this book is a convenient working manual. It has tables of cases and rulings and a convenient chart coordinating the old code with the new. The checklists showing in detail what must be done before and after reorganization if the tax exemption is not to be lost are most helpful. It is an excellent book and should be in the library of everyone concerned with tax problems.

CHARLES L. SAVAGE

Adelphi College
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Book Reviews

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Readings in Cost Accounting, Budgeting, and Control

Edited by William E. Thomas. South-Western Publishing Company, New Rochelle, New York, 1955. Pages: x + 785; $5.20.

At the outset of this review it may as well be stated that there is no intention of passing on the merits of the individual articles constituting this compilation. They are all good. This was certainly to be expected since the articles were screened by the editor and the executive committee of the American Accounting Association. Naturally some articles are better than others; it is always a pleasure to hear or to read articles by Howard Greer, Wayne Keller, and Joel Dean, because of their insight into the problems they deal with, their technical knowledge, and the wide range of the experience they bring to bear upon a specific problem. There is, of course, the danger of suffering mental indigestion upon reading the book. But if one has kept up even moderately with the flow of current literature across one's desk, the book becomes a medium for meeting old friends, a reminder of what is new in the ever-expanding field of the theory and technology of cost accounting.

The anthology, if one may refer to it as such, consists of 57 articles. One-half of these, 28 articles, are taken from the literature of the National Association of Cost Accountants: 24 articles and 4 research studies. A complete tabulation follows:

	Articles	Research Studies
N.A.C.A. Bulletins	24	4
Accounting Review	9	1
Controller	7	
Harvard Business Review	2	
Journal of Accountancy	2	
American Institute of Accountants		1
Miscellaneous (seven different publications)	7	
	51	6

The great debt which cost accountants owe to the N.A.C.A. is apparent at once from this tabulation. The association has pioneered in publicizing and otherwise making available to the profession existing practices through its bulletins. It has emphasized this method of attack through its research series and where it has developed a rationale it has done so only on the basis of exact information gathered in the field.

The book covers a wide field as follows:

	No. of Articles
Historical Development	2
Accounting and Budget Theory for	
1. Management Planning	6
2. Management Control	4
3. Income Determination	5
Problem Areas	
1. Product and Period Costs	9
2. Planning	12
3. Control	13
Reports for Management	6
	57

A supplementary bibliography, classified according to the above tabulation, completes the work and adds to its value.

Certainly the editor has covered a wide field. Criticisms are always possible. For one thing, the research bulletins could have been omitted, since they are readily available, either in special editions or in the original form. This would have made possible more articles to give broader coverage to some topics.

A certain amount of conflict is almost unavoidable in a work of this sort. The borderline between the theory of accounting and budgeting on the one hand and the problem areas of these topics is tenuous at best. It becomes a matter of emphasis. As far as theory is concerned, the editor has done a good job in selecting material whose emphasis is broad and general and may be considered as falling within the field of theory.

There is, however, one exception to the above. To this reviewer, the theory of cost accounting for income determination is the least satisfactory portion of the book. In due time, the cost accountants can be relied on to develop a rationale of their own based upon their experience and outlook, rather than upon the excogitations of financial accountants.

Before a final appraisal is made of the work under review, it might be well to consider another anthology in cost accounting. This was an English work entitled "Studies

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in Costing", edited on behalf of the Association of University Teachers in Accounting by David Solomons, and published by Sweet & Maxwell in 1952. The sponsorship was thus quite similar to what occurred on th s side of the ocean. The English book consists of 26 articles, as against 57 for its American counterpart. There are two articles on the historical development (long ones), five on concepts of costs and costing, nine on costing as a means of planning and pricing, six on costing as an instrument of control, and four on costing in the service of the government.

It was apparent therefore that the general plan in both books is similar, but the American version is more complete (except on the historical aspect), more detailed and more mature. Only two items are duplicated in the two works: Wayne Keller's "Critical Areas of Material Control", and "Assignment of Non-Manufacturing Costs for Managerial Decisions" representing Research Series No. 19 of the N.A.C.A.

Thus in a comparison of the two works, it appears that the American book has a great deal more to offer. There is far greater emphasis in the American work on planning, control, and the relation of cost accounting to the problems of management both on the theoretical and practical levels. But, though the work is of high caliber and covers a broad area, there are some omissions and they are not to be lightly dismissed. Within the past few years highly important developments have taken place which raise cost accounting to new levels of importance. These include the steady *rapprochement* between the industrial engineer, the cost accountant, and top management. More and more it appears that the cost accountant, in order to be able to deal with the host of problems created by modern industry, must master techniques wholly aside from formalistic accounting. He must be thoroughly familiar with the economics of pricing and cost-price-volume relationships. These have indeed been well covered in the book. But surely there should have been included something on operations research, the effect of automation on cost accounting, the role of electronics, the tendency towards centralization of the accounting function as against decentralization of executive responsibility, etc. These are tremendously important areas and their importance will surely increase in the near future. A pity they were omitted. This reviewer was glad to note, though, that at least some attention had been paid to statistical sampling as it affects the work of the cost accountant.

What then is the usefulness of such a compilation? It is a handy secondary source of reference material, valuable as a lead to original sources. Certainly, it could well serve as a text book for an advanced cost accounting course or seminar. For the practitioner, however, this book would not be as satisfactory, say, as the Cost Accountants' Handbook or some other reference work which collects material in a form most useful to one in need of specific information on a pinpointed topic.

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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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The President's Page

THIS month has been marked by an event of great significance to Certified Public Accountants, particularly those in our State and Society. The President of the United States has nominated our fellow member and former Vice President, Percival F. Brundage, for the position of Director of the Budget.

Our first reactions must naturally be as citizens and in national terms. The amazing growth of this country and the ease with which it jumps from one new horizon to another cannot fail to thrill us. However, those with business experience cannot fail to develop corresponding concern as budget, national debt, burden of taxation, and scope of government activities also grow at an accelerated rate. The delicate mechanisms of credit and confidence are also involved. Never did so much seem to hinge on the nation's budget and on the long-range judgments involved in its determination. It is therefore particularly comforting to us as citizens to see the position of Budget Director in the hands of one eminently qualified by his experience in our profession to serve his country in this regard.

Next, as CPAs, we express our gratitude to the many thousands of members of our profession throughout the country who have contributed to civic affairs, particularly at the national level. They have so raised the prestige of the profession in the public eye that the desirability of utilizing the services of its members in civic positions where financial and related matters are involved, is evident.

As members of the New York State Society, we should be grateful that the ticket which took Mr. Brundage from Amsterdam, New York in 1892 to Washington, D. C. in 1956 included liberal stopover privileges in New York and in our Society.

Particular inspiration comes to the newer members of our Society. Nearly 800 have applied for membership since June 1 of last year. Total membership is now over 8,000. In this group must be many who are setting sail on their life's work and who look to the future with curiosity and perhaps some uncertainty. To them especially must come great encouragement from the story of Mr. Brundage's progress from young C.P.A. to prominent national figure. In its light, the belief that in this country the Presidency is open to any man, takes on renewed significance and realism.

From all of us, therefore,

To the President—our congratulations. We deeply appreciate the confidence in our profession which is implied by this latest addition to the list of CPAs in high government office.

To Percival F. Brundage—our congratulations, our thanks, and our heartiest wishes for your continued success in a career which is an inspiration to us all. We know from personal experience that the profession could not be better represented.

HAROLD R. CAFFYN
President

The Advantages Of Professional Organization

By John L. Carey

The American Institute of Accountants has always had an especially close relationship with the New York State Society of CPAs. An obvious reason for this is the location of the Institute's headquarters in New York City. Its staff naturally sees the members of the New York State Society more often than those of more distant states. The New York office is handy for New York Society members to get to, and they are welcome to use the Institute's library and facilities. Institute staff members can go relatively easily to their meetings. The two organizations seem to be the best of neighbors.

Another reason for this close relationship is the important place of the New York State Society in the history of accounting in this country. The Institute frequently refers in background sketches to the fact that New York was the first state to establish the profession on a legal basis, in 1896. Members of the New York Society can be justifiably proud of this heritage, which gives them a longer stewardship for the profession than the other states.

In fact, this long stewardship, combined with the state's economic progress, which has created a greater concentration of accountants here than elsewhere in the country, has resulted in a particularly strong state society in New York. Few other CPA organizations offer their members such an array of services. Here is a paid staff of 18 competent individuals standing ready to provide research and technical information, to represent the Society in talks with legislators, and to carry out public relations activities. Eighteen state societies still have no paid staff at all, although their number is being steadily reduced.

The Society has first-rate publications in *The New York Certified Public Accountant* and the *CPA News*. It offers group insurance at attractive rates. Through its nine Chapters with headquarters in Albany, Buffalo, Rochester, Syracuse, Staten Island, Binghamton, Westchester, Nassau-Suffolk area, and Mid-Hudson area, members have access to a wealth of professional and social opportunities.

Members of the New York Society might well ask what more they could possibly need from professional organizations. Many no doubt feel that membership in the Institute is superfluous—that the services of the two bodies are duplicating, that one can scarcely take advantage of all the opportunities provided by both organizations, and that proximity to the national office of the Institute gives them a chance to use Institute facilities on those occasions when the State Society cannot satisfy a particular requirement.

These questions suggest a more fundamental one: What are the practical advantages to the CPA of belonging to a professional organization? There are, first of all, the essential services mentioned above, which are ably provided to its members by the New York State Society. The Institute is operating in many of these fields, too, but on a national scale. Thus its legislative program deals primarily with the interests of account-

John L. Carey is the Executive Director of the American Institute of Accountants.

ants as they are affected in Washington rather than in Albany, although its staff includes a specialist in state and local legislation who assists state societies on special problems.

The Institute's public relations department develops objectives and programs for increasing the prestige of CPAs throughout the country and creating a better nation-wide understanding of what CPAs do. It directs its attention to the nation's thought leaders of widest possible influence. Its pamphlet, radio and TV programs and speakers' aids are designed for use by all the state societies and are distributed through them.

Other services include the *Journal of Accountancy*, which brings together current thinking and reports on technical developments from all over the country and even abroad. A Technical Information Service, which last year answered more than a thousand inquiries, provides answers to a wide variety of technical questions submitted by members. Members also receive periodical research bulletins embodying new developments in accounting principles and auditing procedure as they are formulated by special committees. At Institute meetings accountants from every state gather to compare notes and combine their efforts in expanding the frontiers of the profession.

There is, however, significance to membership in a professional association even greater than these immediate services. It might be called "enlightened self-interest," because the organization is indispensible to the very existence of the profession. If there were no American Institute of Accountants or equivalent organization, accountants today would never have advanced so far from the narrow range of activities which was typical of the profession fifty years ago. And it is quite possible that they might be operating under strict government controls through which some federal agency regulated accounting principles, procedures and standards. Accounting regulated by the relatively inflexible rules of bureaucracy could never progress as conditions changed.

The accounting profession has custody over the principles and techniques of one of the most important areas of modern society. This is a heavy responsibility, and CPAs generally look to the American Institute for authoritative statements on accounting principles and practices to discharge that responsibility. These principles and procedures become "generally accepted" by accountants and the public throughout the country. It is clearly in the profession's interest that they be developed centrally, in consultation with the state societies, to ensure uniformity. The public, in turn, expects CPAs to conform to these principles and standards. As long as they do conform the courts are unlikely to hold them negligent. Failure to know accounting literature and to keep up with it can cost the CPA dearly if he is sued, and destroy his reputation, on which his livelihood depends.

CPAs thus depend upon each other, through the American Institute, for the maintenance and development of accounting standards. No one of them, no matter how lofty his reputation, could wholly escape the consequences of a loss of public confidence in CPAs as a group. No other profession depends on public confidence to the extent and in the same way as does accounting. The reputation of CPAs generally is the most valuable thing each of them has to offer his client. In a sense, CPAs stand or fall together. They share a kind of citizenship in their profession that is like their dual citizenship in the state and in the nation. It is chiefly in this way that membership in both the state and national organizations constitutes "enlightened self-interest."

There are other direct benefits from membership in the Institute. The In-

stitute's committee on federal taxation has done a huge amount of work on the new tax Code enacted in 1954 and on tax developments which have occurred since then. Last year, for instance, members of that committee and the staff filled more than a hundred speaking engagements in all parts of the country explaining the features of the new act to other CPAs and businessmen. A pattern article on the Code appeared in 171 publications, and 17 individually prepared trade-press articles on it were published. The tax committee has submitted 226 recommendations to the Treasury Department for needed modifications of the new Code, and committee members have also spent long hours discussing proposed regulations with the staffs of the Internal Revenue Service and Congress' Joint Committee on Internal Revenue Taxation.

For the improvement of future tax policy, the same committee has in process studies which include fringe benefits, integration of estate, gift and income taxes, pension and profit-sharing trusts, capital gains and losses, and accounting periods and methods.

These activities do much to identify CPAs with federal tax policy and administration. They are an important public service which comes naturally to the CPA and strengthens his reputation as an authority on tax problems.

Membership in the American Institute also contributes materially to maintaining the standards for admission to the profession, and thus preserving the value of each CPA certificate. The members of the New York State Society are familiar with the CPA examination from experience. They know that it is prepared by the Institute, and that last year New York joined 44 other states whose papers are graded by the Institute. They know that the same examination is given throughout the country, and that this unity of standards is the envy of all other professions. They also know that the public has learned to respect the certificate awarded to those who pass the examination. What they may not always remember is that maintaining these standards is neither easy nor automatic. Defending the value of the CPA's certificate is getting harder all the time, because as the CPA becomes more and more trusted, and as CPAs are given more responsibility, there is greater pressure to let down the standards so that more candidates can enter the profession and share in its benefits.

Most of these things could not be done well, and some of them could not be done at all, except through a national organization of CPAs. Some of the Institute's members never avail themselves of its more direct services, either because they don't happen to need them, or because they are able to obtain them through their state societies. They consider their Institute membership as one means of fulfilling their sense of participation in their profession. They also recognize that the value of the Institute to its members depends on its being truly representative of the profession—that the more CPAs who belong to it, the stronger its voice can be in protecting their interests and increasing the prestige of CPAs everywhere in our society.

Must We Follow A. I. A. Research Bulletins?

By Sidney W. Peloubet, C.P.A.

A. I. A. research committees follow much the same methods that an individual CPA does in resolving accounting problems. The bulletins, reflecting composite experience and judgment of the committees, demonstrate basic concepts and furnish sound patterns of judgment. While the bulletins are most valuable guides to the CPA, he must maintain the integrity of his unprejudiced, informed conviction.

It might be interesting to approach this question first from the point of view of what are the attributes of a good public accountant. With the exception of specific skill and experience, they all center around integrity; different phases of integrity such as independent judgment, appreciation of diverse viewpoints, ability to select sound and adequate evidence, and persistence in maintaining unprejudiced, informed conviction.

The accountant's first responsibility is to be sure of the reality of the factors and the evidence he examines. He must have in mind basic, common patterns of the economy, business, and accounting derived from his wide experience. He must appraise the particular business and its records in the light of being reasonable, understandable and consistent with these basic patterns.

Sidney W. Peloubet, C.P.A., is a former chairman of the Society's Committee on Accounting Procedure. He is also a member of the American Institute of Accountants, the National Association of Cost Accountants, and the Institute of Internal Auditors.

Mr. Peloubet is a partner of Pogson, Peloubet & Co., CPAs.

This paper was presented by him at a recent technical meeting of the Society conducted under the joint auspices of its Committees on Accounting Procedure and on Auditing Procedure.

He accomplishes his work by three steps:

First—He examines and reviews transactions as originally recorded.

Second—He adjusts them, where necessary, to complete the records and make them consistent.

Third—He considers and resolves special or new situations, to be sure they are expressed in the financial statements in such a way as to give a true picture of the business.

A good CPA acquaints his client with generally accepted accounting and financial practices, and will encourage compliance in order to help maintain a community of understanding in which business transactions may be conducted with confidence between individuals.

The bulletins are a great aid to the CPA because they create a climate of accounting and auditing concepts and thinking, a climate in which it is easier and more secure to study day-to-day problems of valuation, classification and presentation.

In treating with special and new questions, the bulletins use various accounting and auditing concepts to arrive at logical, reasonable conclusions. These concepts are the same ones that every good CPA must constantly consider in his work.

Examples of these concepts would be:

1. Disclosure and materiality.

2. Matching revenue with related cost and expense.

3. Relation of current market to cost values.

4. Effect of business operating cycles on income and position.

There are many others, of course.

In the illustrations and argument of the bulletins these concepts are repeatedly referred to, although there is no specific mention of them in any of the bulletin titles. The subject titles of the bulletins will change as accounting practice changes and follows economic development; these concepts, however, will never change and are the underlying building blocks of all auditing and accounting research.

The bulletins represent the committee's opinion of the best current practice at the time they are issued. As conditions change, the bulletins may be amended or withdrawn. Number 1 (the only accounting bulletin adopted by the A. I. A. membership) lists six rules. The very first one includes an exception to the rule. Several bulletins not only recommend procedures but also suggest alternatives as well. This shows that the real intent of the committee has been to orient the individual accountant seeking guidance in the subject under study, rather than to furnish a categorical answer. This is further borne out by the fact that many tentative bulletin texts were remolded and mellowed as the result of having been circulated among State societies and educational organizations for comment before they were issued. Some tentative texts were dropped and not issued.

The bulletins are arrived at by intensive study with much the same approach the individual practitioner uses to accomplish his work. The three steps are like those given above:

First—Accumulate significant information.

Second—Classify and unify conclusions.

Third—Apply these to special or new situations.

There is an important difference, however, between an individual accountant's study and that of the research committee. The individual must arrive at a sound solution of a specific problem, while the committee arrives at an illustrative conclusion based upon the composite experience and conviction of its members. Many bulletins were published with dissents by one or more committee members, showing that uniformity of opinion did not exist although every opportunity was available to come to some common ground of agreement. This should convince us that the value of the bulletins lies in disclosing the concepts involved and the viewpoints considered, rather than as a specific solution or rule.

The subject of the bulletins, accounting and auditing, deals with measures; measures and the recording of measures in an orderly, consistent way so as to identify and reflect an inherent pattern. Accounting and auditing procedures are a means to an end, a medium of expression. While this way of expression is important, the *soundness* and *truth* of the *business* policy and practice of operation expressed by them is of primary importance. We must use whatever method will best give us a true picture of the business. Should the use of a rule distort or confuse this picture, we should *not* apply it.

Accounting Bulletin # 43 states in the introduction (page 9, 3rd sentence of paragraph 8) that should we depart from accepted procedures we must assume the burden of justifying our departure. We should keep in mind, however, that we must not only assume the burden of justifying departures from bulletin procedures but that we must assume the burden of justifying *every* procedure we use. The sole responsibility for the selection of techniques and procedures rests with the individual who selects them, including the extent to which they are applied, both as to inadequate and excessive application. The test of adequacy is understanding, honest conviction.

We cannot afford to be preoccupied with the medium of expression and so fail to see through it to the pattern of operation. The entire accounting pattern and form must be subordinate to the substance of the transactions which are expressed.

We must look through, see beyond accounting and auditing throughout our work, in order to deal intelligently and consistently in challenging the presentation of the progress and position of a company.

In a sense there is no accounting policy. There is only business policy reflected in accounting. We must be as resourceful and ingenious as we can to reflect business policy in accounting methods and terms, but the sound accounting pattern is always derived from the pattern of business.

In order to assure as much freedom of judgment and action as possible in our professsion, and to avoid possible government interference, we instituted committees and public pronouncements in 1938. Insofar as these pronouncements are the recital of useful concepts and examples of logical application, they are very important guides in the exercise of good judgment.

There is protection in this recital, as it raises standards and furnishes helpful patterns of sound reasoning. The issuing of completely hard and fast rules or directives binding our actions would, however, be detrimental. Four walls make a shelter and haven. They also may make a prison.

Our real objective is dependable, consistent work maintained by high standards; high standards maintained by self-discipline; and self-discipline promoted in a climate of intelligent thought and freedom of judgment.

One of our real problems today is obtaining good recruits for the profession. We must keep it a profession of responsible, dependable, informed accountants or we will not attract talent.

Every accountant is a lone wolf and must separately maintain his integrity and independence of viewpoint. No authority can relieve him of his responsibility, and, to the extent he is governed, rather than guided, by research bulletins he no longer speaks with conviction, independent judgment, multiple viewpoint, from sound and adequate evidence and no longer voices an unprejudiced, informed opinion.

How happy is he born and taught,
That serveth not another's will;
Whose armour is his honest thought,
And simple truth his utmost skill.

The Criminal Liability of Accountants

By Joseph M. Gasarch, C.P.A.

In this paper the author outlines the provisions of some of the criminal statutes applicable to the professional practice of accountancy.

Over the years there have been relatively few cases involving accountants' civil liability, but there have been even fewer criminal prosecutions of accountants. They can be justifiably proud of this record.

It is interesting to note that about a half-dozen western states have provisions in their laws that apply directly to certain misdeeds of accountants. Typical of these statutes is the law in Arkansas which provides that:

> "If any person practising in the state of Arkansas as a Certified Public Accountant, under this Act, or who is in the practice of Public Accountancy as a Certified Public Accountant, or otherwise, shall knowingly or wilfully, falsify any report or statement bearing on any examination, investigation or audit made by him, or under his direction, or make any false certificate, he shall be deemed guilty of a misdemeanor."

However, an accountant with a sinister disposition should draw no comfort from the fact that there is no analogous law in our state. None is needed. In New York, it is a crime for any person to issue a false financial statement, so that the unscrupulous accountant who aids his client in the preparation of such a statement is just as guilty as his client. This is so because, under our laws, an accomplice is a principal. An accountant is criminally liable for any transgression of the Penal Law by his client, if he aids or abets him in the commission of the crime. In other words, an accountant could become an accomplice in the execution of a criminal design.

Criminal liability entails a different degree of proof than is required in civil cases. However mistaken one may be, or no matter how unfortunate the consequences of an accountant's error might be, in the absence of a wrongful or criminal intent the accountant cannot be held criminally responsible. Even such negligence as would constitute fraud in a civil case, is not criminal if the acts were performed without guilty knowledge or a criminal intent.

There are a number of provisions in the Penal Law of New York, under which accountant-malfactors may be prosecuted for criminal misdeeds in the practice of their profession. In this limited presentation, I shall refer only to some of the applicable statutes.

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Mr. Gasarch is also a member of the New York Bar and is now serving as Assistant District Attorney and Chief Accountant in the office of the District Attorney of New York County.

He holds the degrees of B.C.S. and LL.B. from New York University and LL.M. from St. Lawrence University. He has lectured extensively on the problems of internal control and fraud before various accounting societies.

This paper is based upon an address delivered by Mr. Gasarch before the technical meeting of the Society held on October 27, 1955, at the Engineering Societies Building, under the auspices of the Committee on Insolvency and Bankruptcy Procedures.

False Financial Statements

Section 1293b of the Penal Law makes it a misdemeanor for any person to obtain property or credit by the use of a false financial statement. This section provides in part that:

"Any person

"1. Who shall knowingly make or cause to be made, either directly or indirectly, or through any agency whatsoever, any false statement in writing, with intent that it shall be relied upon, respecting the financial condition, or means or ability to pay, of himself, or any other person, firm or corporation, in whom he is interested, or for whom he is acting, for the purpose of procuring in any form whatsoever, either the delivery of personal property, the payment of cash, the making of a loan or credit, the extension of a credit, . . ., or

* * *

"3. Who knowing that a statement in writing has been made, respecting the financial condition or means or ability to pay of himself or such person, firm or corporation, in which he is interested, or for whom he is acting, represents on a later day, either orally or in writing, that such statement theretofore made, if then again made on said day, would be then true, when in fact, said statement if then made would be false, and procures upon the faith thereof, for the benefit either of himself or of such person, firm or corporation, either or any of the things of benefit mentioned in subdivision one of this section,

"Shall be guilty of a misdemeanor."

Some years ago an accountant together with his client were charged with the crime of issuing a false financial statement under this provision of the Penal Law. The statement was false principally due to an overstatement of accounts receivable and an understatement of accounts payable. Included in the accounts receivable shown on the balance sheet were accounts long past due, loans due from officers, and charges for merchandise which had not been shipped at the statement date. The liability for some merchandise received prior to the statement date was omitted, as well as a liability for payroll taxes.

The accountant's defense was that he had no criminal intent; that he had been merely negligent and had exercised bad judgment. Both defendants were convicted. The Court was of the opinion that, under the circumstances of the accountant's detailed audit, there was a conscious concealment of liabilities and an unjustified inclusion of worthless assets in the financial statement, and that the proof demonstrated the defendant's guilty knowledge.

The accountant raised some other interesting defenses. He contended that, since the verification of the statement was not signed by him but rather by his partner, he could not be charged with a crime. The proof established, however, that the defendant had prepared the false statement, that his partner had no knowledge of the client's affairs, and that the partner had signed the verification only after having been assured by the defendant that the statement was true in all respects.

The accountant's verification here took the form of answers on a questionnaire submitted by a credit agency. In this case, the credit agency had furnished the complaining creditor with a copy of the balance sheet, but had made no reference to the verification. Nor was the creditor aware of the existence of an accountant's verification.

On appeal from his conviction, the defendant contended that the verification was an integral part of the statement and, since the verification was not seen by the creditor, that he could not be guilty of having obtained property or credit by the use of this statement.

It was the contention of the prosecutor, however, that since the defendant had played a major role in the preparation of the false statement, it was of no consequence that the verification was not shown to the complaining creditor. He further contended that the verification was of the same cast as the statement itself—false and fraudulent.

The appellate court affirmed the conviction unanimously, without a written opinion.

We have found that in most instances accountants become criminally involved as a consequence of their desire to aid a distressed client. A debtor will sometimes resort to fraud in a vain hope that his business can thus be saved. He will plead with his accountant to aid him, arguing that his present financial embarrassment is temporary; that no one would be injured by a false statement, since profits of the immediate future would restore his solvency. Such hope and optimism are generally unjustified.

When an accountant succumbed to such blandishments, probably in the hope that he would thus avoid the loss of a client, he was charged with the crimes of conspiracy and of issuing a false financial statement. To add insult to this injury, it was in just such a case that the client pleaded ignorance of the contents of the statement. He maintained that the statement was prepared by the accountant; that he knew nothing about the financial details of his business; and that he was misled by bad accounting advice.

Since the commercial community is aware that businessmen rely heavily on their accountants' advice and guidance, this defense was, in at least one case, almost successful. The accountant's plea that the falsification was due to the fact that he prepared the statement under the pressure of time was likewise not sustained.

Larceny by False Representations

In addition to the crimes of issuing a false financial statement and conspiracy, accountants may also be liable for the crime of larceny by false representations under Section 1290 of the Penal Law.

As understood in the criminal law, this crime imports an intentional false statement concerning a material matter of fact upon which the creditor relied when he shipped merchandise or made a loan. If the amount obtained in this manner exceeds $100.00, the crime is that of grand larceny in the second degree; if more than $500.00, the crime of grand larceny in the first degree is committed. Both these degrees of grand larceny are felonies.

Forgery

Are you aware that it is possible to perpetrate a forgery not by writing, but by a failure to write? Do you know that to destroy a page in a cash book, or a journal, or a ledger, or to destroy an entire book of account, may under certain conditions also be a forgery? These interesting possibilities and the circumstances under which they are considered criminal are set forth in Section 889 of the Penal Law.

By virtue of the provisions of a portion of that statute, it is a forgery in the third degree (a felony) to falsify, alter or destroy books of account, as well as to fail to make a material entry, if done with the intent of defrauding creditors.

Subdivision 4 of the second part of Section 889 provides that:

> "The altering, erasing, obliterating, or destruction of any account, book of account, record, or writing, or the making of a false entry in an account, statement of financial condition, or book of accounts, or the willful omission of material entries in such account, statement or books of account, by any person whether by his own hand or the hand of another, if made with intent to defraud creditors or to conceal a crime, or to conceal from creditors or stockholders or other persons interested matters materially affecting the financial condition of any individual, corporation, association, or partnership; or to provide a basis for the obtaining of credit or property by or for such individual, corporation, association, or partnership, shall render such person guilty of forgery in the third degree, within the meaning of this section; . . ."

Where an accountant advised and aided the officers of his corporate client

in making false entries in a cash book so as to disguise the true nature of some disbursements, and thus enabled them to carry out a scheme of larceny and fraud, he too was charged with larceny and the crime of third degree forgery.

Other Crimes

The portions of the New York State Penal Law alluded to here are but illustrative of the type of criminal liability which may have some interest to accountants. There are others such as Sections 810 and 811, felonies, which deal with the forgery of records to be used as evidence, and Section 665 which makes certain misconduct of directors, officers, agents and employees of corporations a misdemeanor.

Section 811 provides that:

> "A person who fraudulently makes or prepares any false record, instrument in writing, or other matter or thing, with intent to produce it, or allow it to be produced in evidence, or on a motion, as genuine, upon any trial, hearing, investigation, inquiry, or other proceeding authorized by law is guilty of a felony."

An accountant was indicted under this provision of law when he attempted to cover up certain corrupt payments recorded in his client's books. He directed the eradication of pertinent journal entry explanations and supervised the rewriting of various pages in the general journal.

It should be noted in passing that accountants can also be held criminally liable for their misdeeds under the State and Federal tax laws as well as under various other federal statutes.

Disciplinary Proceedings

We have discussed briefly the nature of the accountant's criminal liability. In addition to this, most of the states have provision in their laws for disciplinary proceedings against wayward accountants. Section 7406 of the Education Law of New York State provides that the Regents shall have the power to revoke or suspend the certificate of a Certified Public Accountant or to censure him when he has been found guilty of fraud, deceit, or gross negligence in the public practice of accountancy or has been convicted of any crime in a court of competent jurisdiction either in New York State or elsewhere.

An accountant's certificate may also be suspended or revoked by the Regents of New York State if he has been found guilty of unprofessional conduct as defined in Section 94 of the Regulations of the Commissioner of Education.

* * *

I am sure that the dangers outlined herein, are only of academic interest. Our profession ranks high in the observance of proper legal and ethical concepts. Accountants have been of great service to clients by helping them avoid the pitfalls some may dig in desperation. By exercising his responsibility to himself, his profession and the public, the accountant has demonstrated that his profession has come of age.

Annual Reports to Employees

By John H. Myers, C.P.A.

This article is a comprehensive analysis of some sixty of the several hundred corporate annual financial reports to employees the author has had occasion to review. It discusses the methods of presentation and choices of what data to present to employees. The companies range from large to small, and all reports referred to were used for general interest rather than in any attempt to make a statistical determination of what is usual.

Annual reports to employees differ markedly from company to company. In about half of the companies studied they also differ from year to year. As to financial information given, they range from being almost a reprint of the report to stockholders, as in the case of American Can Company, to giving no financial information at all. An example of this latter is Esso Standard Oil Company which has not even stockholders to report to in the usual sense of a stockholders' report, since it is wholly owned by Standard Oil Co. (N. J.). The reports range in tone all the way from a report of the people, by the people, and for the people (Allstate Insurance Company) to those where the management just talks to the employees in a patronizing air or to those where the management talks without seeming to make an attempt to communicate anything. One company, to which I wrote for a copy of its report, had given up the attempt to tell its employees about the company and replied that "the sad experience is that most employees are really not interested in the company for which they work."

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Dr. Myers has published many articles in financial and accounting journals.

Distribution of the Sales Dollar

Most of the companies give a distribution of their sales dollar even if no other financial information is given. Of course, there are cases where this is merely an extra column on a formal income statement; but far more interesting are the efforts by some companies to put in a down-to-earth presentation designed to get the point across. Several companies illustrated a dollar bill divided into various parts; many others used a silver dollar which was divided into segments like the traditional pie chart. Less effective were the illustrations of piles of change of various denominations. For example, if forty-seven cents of each dollar went for materials, there would be a picture of a quarter, two dimes and two pennies. Effectiveness seemed to be lost because the concept of proportionate size was lost. The reader had to read the numbers or count his change instead of just looking.

Sometimes there may be a considerable propaganda element to the presentation, in the desire to show the employees what a large share of the "pot" they really are getting. The Daystrom Company's illustration was most effective from this point of view. For the sales during the year there was a picture of a fellow carrying a sack of one hundred marbles. In the next picture all one hundred were in a circle on the ground and a man, representing all suppliers, was taking a

shot at them and knocking out fifty-two of the marbles. The following picture showed an employee knocking out forty of the remaining forty-eight; he really made a killing. Others in turn took their shots at the remaining marbles until, in the end, the owner came along and picked up the one remaining marble.

A couple of companies illustrated the income statement in total, instead of in percentages to net sales, as in the cases previously mentioned. Lion Oil Company made an interesting presentation. The report was about the size of an unfolded pocket checkbook. The first page was a deposit slip for the amount of the total net sales. Each succeeding page was a check to one group of recipients: suppliers, employees, government, owners, etc. Opposite each check was a small stub with the balance brought down and next to the stub was a fairly complete discussion of the item.

Marquette Cement Manufacturing Company also used the check book idea, but supplemented the presentation with a pile of one hundred pennies. First this was divided into two parts: "for costs ahead of us" and "balance left to us." Each of these parts was in turn divided into three parts. The first was split among materials and services, taxes, wear and tear. The second was split among employees, investors, and used in the business. Kimberly-Clark Corporation's pictorial device was a crane taking logs away from a pile of pulpwood. Several other companies similarly had their pictures tied in with their operations.

Other Statistical Data

Only a few companies made any attempt to give the employees balance-sheet information. Some of these, of course, were like American Can, which gives the employees regular statements. Other companies have gone to elaborate means to make the statements self-explanatory. Kimberly-Clark's simplified balance sheet apparently has all the items appearing on the one to stockholders, but also has from two to five lines of explanation under the traditional balance-sheet wording. The Garrett Corporation, in its one report to employees, gave a standard-form balance sheet with lines to explanations out at the side. Radio Corporation of America merely listed the assets with descriptive titles under the heading "What We Own." Similar treatment was given to "What We Owe" and "Owners' Investment." A typical description was "Unpaid bills and accruals to be paid within one year."

In addition to typical income-statement and balance-sheet data, a number of companies show employment statistics. Most common is the showing of payroll plus fringe benefits. A number of companies have set forth comparisons to show the employees how well-off they are. Revere Copper and Brass, Incorporated, presents a graph and a brief discussion of seven different items. Four relate to Revere only—average earning per employee, total payroll, average wages per hour, and average weekly wages and hours. Then there follows a graph of Revere weekly wages and of the cost of living index. The next graph shows three lines: Revere hourly wages, hourly wages in durable goods manufacturing, and in all manufacturing. The last graph shows weekly wages for the same three groups. Marquette Cement does somewhat the same thing with comparisons. One especially interesting one shows productivity per hour (up slightly) and productivity per dollar of pay and benefits (down considerably).

Two companies, Bethlehem Steel Corporation and Esso Standard Oil, have given a considerable amount of extra statistical information. Bethlehem, in a single two-page table, gives data since 1905 on nineteen different items—the same table as in the stockholders' report. Esso's data cover only five years and only a few topics, such as costs of crude oil purchased and an

example of the effect of price variation upon the company.

Non-numerical Topics

In addition to the statistical reports, a number of the companies have covered further ground. This might be classified into two types: about the company and about the people. At the two extremes might be placed the 1952 reports of Bethlehem Steel and Allstate Insurance Company. Bethlehem has separate articles on capacity, facility improvements, mining property improvements, taconite, shipyards, etc. Allstate has mostly reviews of what its people have said and done. There are sections on sports, anniversaries, manpower needs, employee education, and others. Only about one-third of the report was devoted to operating data. However, in 1953 the company switched to giving more company data. R.C.A. gives articles on its research, manufacturing, broadcasting, communications, and newly-promoted executives among others. Esso discusses marketing trends, product development, merchandising, refining operations, and "people events."

Tone

The tone of the reports varies widely. Some assume the employees should be addressed on the same plane as the stockholders. Others would seem to reject this viewpoint. American Can's report to "the organization" is essentially the stockholders' report with the jacket and salutation changed. At the opposite extreme, another company set up its report in comic-book style a number of years ago. It apparently realized its error, for subsequent reports have been quite different.

Some of the reports are written as if the employee reader is genuinely interested. Others just report. Many experts on communication today tell us that we should put the human side foremost. Throughout the R.C.A. report a person is prominent in every picture. Marquette Cement has appropriate cartoons on people in the margins, pointing up the significant parts of the story. American Can's report, being as erudite as it is, has no pictures except in the customary "rogue's gallery" of executives.

Evaluation

An evaluation of annual reports to stockholders is not difficult if one confines himself to matters of accounting reporting. Standards are rather well defined, and there seems to be a direction in which these standards are moving. The text part of those stockholders' reports varies widely, but in most cases is somewhat related to the financial statements. However, with employees' reports there is no standard against which to judge except effectiveness. How can an outsider judge if it was effective? What message was the report supposed to convey effectively? The real answer is that there is no uniformly understood objective as to what employees' reports are to achieve, what the employees want to know, or how to get the message across to them. Some companies apparently try to use the reports as propaganda devices to "butter up" the employees by showing them how well-off they are. Others try to arouse their sense of pride by telling them about the wonders of their company. Some, like the example of Marquette Cement, try to stimulate employees to greater efforts by showing them that wages have gone up faster than productivity. Still others try to make it a report of how their fellow employees are doing.

Some of the annual reports to employees are incorporated in the regular company magazine. Most are separate publications. It would seem that if the magazine is effective, this would be a place to put the report to get it read. Almost all companies offer the employees the regular report to stockholders if they wish it, and tell them how to get it.

(Continued on page 122)

Automation—1894

By THE COMMITTEE ON HISTORY

In assessing the wonders of today's computing machines let us not overlook the impetus given to machine bookkeeping by Charles Ezra Sprague, CPA, banker, teacher, author of the first CPA law, and member of New York State's first Board of Examiners.

A brilliant student, he had an aptitude for languages and is said to have spoken sixteen, including Esperanto and the somewhat less publicized Volapuk, on which he wrote a book. His usefulness as an interpreter got him a job as clerk in the Union Dime Savings Bank in 1870, when he was around twenty-eight years old. Twenty-two years later he became president of the bank and remained in that post until his death in 1912, at the age of seventy.

According to the biography of Colonel Sprague written by Helen Scott Mann, published by New York University in 1931, he fathered many improvements in savings-bank bookkeeping, but none more revolutionary than the machine, known as a *teller's machine*, which was developed under his guidance.

The biography tells us that, because of his liking for a young reporter in need of copy, he outlined his idea of a machine that would make bookkeeping entries, and found himself so deluged with inquiries from prospective users that he was obliged to do something about it. So he took his ideas to a machinist and around 1894 or 1895 the first savings-bank-teller's machine was born. In one operation it made the necessary entry in the depositor's passbook, recorded it for the bank's records, and accumulated the day's total. Rather dismayingly called an *automalogothotype,* it was the first savings-bank-teller's machine, though not, of course, the first adding machine. The Union Dime Savings Bank is said to have had two of them, one for deposits and one for withdrawals. It appears that this was the machine described in United States patent No. 570,620, issued to Leicester Allen of Brooklyn, N. Y., on November 3, 1896, on an application filed October 15, 1895.

These seem to have served the bank's purposes until about 1908 or 1909, when Colonel Sprague negotiated with The National Cash Register Company for the development and purchase of newer machines to replace the Allen-type machines. The first NCR machine, their class number 1200, bearing the factory number 872,430, was delivered to the bank in August, 1910. It is fully described in United States patent No. 1,198,418, issued to William A. Chryst on September 19, 1916, on an application filed September 21, 1911. This was the first of ten machines which were built and delivered to the Union Dime Savings Bank between 1910 and 1917.

According to information supplied by Carl Beust of the patent department of The National Cash Register Company, who was present at the installation of the machine in August, 1910, no other machines of this type were ever built by the company for any other bank.

In October, 1955, the Union Dime Savings Bank put on display in its Madison Avenue office one of these old machines, flanked by a portrait of Colonel Sprague.

This is the sixteenth in a series of articles on the History of Accounting in the State of New York. It was prepared by the Society's Committee on History.

Codification of Statements on Auditing Procedure

The Board of Directors of the Society feels that the growing acceptance by the profession throughout the country of the pronouncements of the Committee on Auditing Procedure of the American Institute of Accountants, makes it a matter of great importance that all members of the Society be fully informed with respect to them. Accordingly, it has been decided to publish, in serial form, in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, *the two principal Institute publications in which they are set forth, namely, "Generally Accepted Auditing Standards, Their Significance and Scope", and "Codification of Statements on Auditing Procedure". The following reprint is the first in the series dealing with the "Codification".*

HISTORICAL PREFACE

IN 1917 the American Institute of Accountants, at the request of the Federal Trade Commission, prepared a "memorandum on balance-sheet audits," which was endorsed by the Commission, published in the Federal Reserve Bulletin, and distributed in pamphlet form to banking and business interests and to accountants under the name of *Uniform Accounting: a Tentative Proposal Submitted by the Federal Reserve Board.* It was reissued in 1918 under a new title, *Approved Methods for the Preparation of Balance-Sheet Statements,* the change indicating perhaps a realization of the Utopian quality of uniform accounting as an objective.

In 1929 the pamphlet was revised in the light of the experience of the decade just elapsed. In addition to a further change in title, which became *Verification of Financial Statements*—as evidence of the growing consciousness of the importance of the earnings statement—the revision contained the significant statement that "the responsibility for the extent of the work required must be assumed by the auditor."

In 1936 the Institute, as spokesman for a profession which had by that time become well established, revised the previous pamphlets and issued under its own sponsorship a pamphlet entitled *Examination of Financial Statements by Independent Public Accountants.* Two interesting developments appear here: realization that the word *verification,* previously used in the title, is not an accurate portrayal of the independent auditor's function in the examination of financial [**page 6***] statements; and assumption by the accounting profession of the responsibility for determination and enunciation of accounting and auditing procedures.

The profession grew rapidly and at the same time the complexities of modern business were increasing the diversity of conditions encountered by the accountant. Rather than continue the practice of revising a document which, at best, could be applicable to only a small segment of the industrial field, the Institute issued from time to time, through its committee on auditing procedure, a series of *Statements on Auditing Procedure* which represent the opinion of the committee (reinforced in the more controversial matters by membership

* This reference, and those which follow in the same form, are to the paging in the official edition of this publication. This will facilitate the use of the cross-references appearing in the original document.

approval at annual meetings of the Institute) on certain auditing procedures as restricted to the particular circumstances recited therein. These pronouncements in effect modified or superseded parts of the 1936 pamphlet.

When the Securities and Exchange Commission initiated the proposal that a representation as to compliance with generally accepted auditing standards be introduced into the independent public accountant's report relating to companies which file with the Commission, it became apparent that a statement was needed which would define these standards. Accordingly, the committee undertook a special study of auditing standards (as differentiated from auditing procedures) and submitted a report which was published in October, 1947, under the title *Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope.* The tentative character of this brochure vanished when, at the September 1948 meeting, the membership of the Institute approved the summarized statement of auditing standards appearing therein.

By 1948 developments in auditing procedure which had taken place since the publication of *Examination of Financial Statements by Independent Public Accountants* were so extensive that it was considered advisable to withdraw it from distribution. Accordingly, it is now out of print. It has been supplanted by the statement of auditing standards, the series of case studies in auditing procedure, and this booklet, all issued by the committee on auditing procedure; by the series of accounting research bulletins issued by the Institute committee on accounting procedure; and by the booklet *Audits by Certified Public Accountants,* issued by the Institute research department.

The committee on auditing procedure also made a comprehensive study of internal control, a subject to which the scope and size of the [**page 7**] business entity in recent years have given great importance, because of the protection it affords to business and its potency in eliminating unreasonably extensive independent audit procedures. The results of this study were published in 1949 under the title *Internal Control—Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant.* Publication of a series of case studies in internal control has since been instituted.

The committee on auditing procedure had its beginnings in 1939 when, on January 30, the executive committee of the Institute authorized the appointment of a small committee "to examine into auditing procedure and other related questions in the light of recent public discussion."

On May 9 of that year the report of this special committee was adopted by the council of the Institute and authority given for its publication and distribution, and in the same year the by-laws were amended to create a standing committee on auditing procedure.

In 1941 the executive committee authorized the issuance to members, in pamphlet form, of the official *Statements on Auditing Procedure,* prepared by the committee on auditing procedure, previously published only in issues of *The Journal of Accountancy.*

These pronouncements were designed to guide the auditor in those areas of specific situations encountered in practice in which he must exercise judgment, situations outside the realm of textbooks, whose function is inherently to describe procedures in general.

Twenty-four statements have been published during the past ten years. The first dealt with extensions of auditing procedures with respect to inventories and receivables, a subject of intense public interest in the 1930's. Another,

arrived at after long discussion with the Securities and Exchange Commission and the Committee on Stock List of the New York Stock Exchange, sponsored an approved form of short-form report. In general, the statements covered those subjects as to which current conditions, special studies, or developments in auditing thought have made official pronouncements advisable. In some instances the subjects dealt with were of only temporary significance. In others, statements were issued to clarify auditing concepts discussed in earlier statements.

This *Codification of Statements on Auditing Procedure* has been prepared by the committee on auditing procedure to consolidate the more valuable and currently useful features of these pronouncements. In the process of codification:

a. Ambiguities contained in Statements Nos. 1, 3, and 12 have **[page 8]** been clarified respecting the expression of an opinion in the rare situation where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out, but other procedures are employed which justify the expression of an opinion (see fourth paragraph page 21). Effect has also been given to Accounting Series Releases Nos. 62 and 70 issued by the Securities and Exchange Commission, the former relating to the independent public accountant's responsibility for earnings tables in registration statements and prospectuses and the latter to an amendment of Regulation S-X, by which Rule 2-02, quoted herein, was amended.

b. Statements Nos. 7, 9, 10, 15, 17, 20, and 21 have not been summarized herein because the material contained in them applies to special situations, such as those which arose in World War II.

Therefore, this codification presents the principles and procedures of continuing general interest included in *Statements on Auditing Procedure,* Nos. 1 to 24, inclusive. For the convenience of those interested in the detail of the statements, whether or not summarized herein, a complete list of the 24 statements issued to date is included in the appendix.

APPOINTMENT OF THE INDEPENDENT AUDITOR

The method of appointing the independent auditor and his status in relation to the client are subjects of great importance to all who rely upon his findings.

In addition to professional skill and competence, his independence must be assured if his opinions are to possess the impartiality necessary to make them dependable. To be independent he must be intellectually honest; to be recognized as independent he must be free from any obligation to or interest in management, owners, creditors—or others entitled to rely on his report—which might influence his judgment as to the fairness of the financial statements.

To emphasize his independence of management many corporations affected by public interest follow the practice of having him engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations provide that the stockholders be given an opportunity to ratify the selection made by the directors.

Not only the method but the time of his appointment is important. Both he and his client benefit when he is engaged early in each fiscal year so that he may carry out part of his work during the year. In **[page 9]** many respects proper

execution of audit procedures depends on early consideration of preparatory measures. This is conspicuously true with respect to observation of physical inventories, where early planning is frequently vital. Considerable advantage may also accrue from the opportunity afforded him of bringing about correction of any operating procedures or accounting practices which are undesirable from an audit standpoint, in time for beneficial effects upon the situation which he will later face. And in the interest of more efficient audits, swifter completion after the year-end, and improved staff morale, too much stress cannot be placed on the opportunity which early engagement affords for performing useful preliminary work and spreading audit service more evenly over the year.

AUDITING STANDARDS

Auditing standards are the underlying principles of auditing which control the nature and extent of evidence to be obtained by means of auditing procedures. Application of generally accepted standards does not imply that in a particular case all procedures were followed which would be followed in the majority of cases. It implies, rather, examination of evidence which certified public accountants generally would consider adequate in the particular circumstances, and may call for the extension of normal procedures or the employment of additional procedures.

As the result of its special study made for the purpose of determining and explaining these standards, the committee issued in 1947 a *Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope.* The summary of the meaning of generally accepted auditing standards appearing on page 11 of that report was approved by the membership of the American Institute of Accountants at their meeting of September, 1948. The resolution reads in part as follows:

WHEREAS the committee on auditing procedure of the American Institute of Accountants in a special report (*Tentative Statement of Auditing Standards*) issued in October, 1947, among other things has stated that

> "While it is not practicable, because of the wide variance of conditions encountered, to issue anything like an 'all-purpose' program of auditing procedures, it is possible to formulate a pronouncement with regard to the auditing standards requiring observance by the accountant in his judgment exercise as to procedures selected and the extent of the application of such procedures through selective testing." (Paragraph 6, page 7.)
> **[page 10]** and that
>
> "Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. Auditing standards as thus distinct from auditing procedures concern themselves not only with the auditor's professional qualities but also with his judgment exercise in the conduct of his examination and in his reporting thereon." (Part of the first paragraph, page 9.)

and has presented the following brief summary of the meaning of generally accepted auditing standards (page 11):

"General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

"Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

"Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Now, Therefore Be It Resolved, That:

(a) The foregoing excerpts from the committee's report are hereby approved and adopted,

(b) The use of "generally accepted auditing standards" in the re- **[page 11]** ports or certificates of independent auditors shall be deemed to refer to the standards or principles set forth in the foregoing summary. . . .

The foregoing action gave official status to the meaning of the term "generally accepted auditing standards" which had been used for several years in the accountant's short-form report. For detailed exposition of the standards and of their application in practice, the booklet *Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope* should be freely consulted.

Approved standards of reporting in the fairly extensive situations where financial statements are presented on the stationery or in a report of an independent certified public accountant without an expression of opinion are discussed in some detail herein under the heading *Clarification of Accountant's Report When Opinion Is Omitted* (pages 18 to 20 hereof).

RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR

The primary purpose of an examination of financial statements by an independent certified public accountant is to enable him to express an opinion as to the fairness of the statements, their compliance with generally accepted accounting principles, and the consistency of the application of those principles with that of the preceding period.

In the performance of the duties which lead up to this opinion the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The generally accepted standards of his profession require that technical training and proficiency be supplemented by independence in mental attitude and due professional care in the performance of the examination and preparation of the report.

In offering his opinion the independent auditor assumes heavy responsibilities. He must have made a reasonable examination of the accounts to warrant an expression of opinion. He must state his opinion clearly and unequivocally. Since he must bear the burden of justifying this opinion, it is his ultimate and inescapable responsibility to adopt such procedures as in his professional judgment are appropriate. His judgment is not expected to be infallible but is logically required to be the informed judgment of a qualified professional person.

The independent auditor's function is to examine a concern's accounting records and supporting data, in certain matters to obtain **[page 12]** outside confirmations, and to require and consider supplementary explanations of management and employees, to the extent necessary to enable him to form an opinion as to the fairness of the financial statements as submitted.

Generally speaking, his function is limited to reporting upon situations that have taken place in the past.

Management has the direct responsibility for maintenance of an adequate and effective system of accounts, for proper recording of transactions in the books of account, and for safeguarding the assets. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations. The transactions with which the accounting records have to do and the recording of those transactions in the books and accounts are matters within the direct or primary knowledge of the company; the independent auditor's knowledge of them is a secondary one, based on his examination. Accordingly, even though the *form* of the statements may show the influence of the accountant—it can do so only if the company accepts, and adopts, the form of disclosure advised by the accountant—the *substance* of the financial statements of necessity constitutes the representations of the company. The independent auditor's representations, therefore, are confined to and expressed in his report, or opinion, upon the statements. The pronouncements of the Institute to this effect have been given the added weight of general affirmation by the Securities and Exchange Commission.

The well-established custom of making test checks of accounting records and related data and, beyond that, relying upon the system of internal control after investigation, through appropriate checks, of its adequacy and effective functioning, has with very few exceptions proved sufficient for the purpose of expressing an opinion.

The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed ***and cannot be relied upon*** to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organized concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive. It is generally recognized that

good internal control and surety bonds provide protection much more cheaply. On the basis of his [**page 13**] examination by tests and checks, made in the light of his review and tests of the system of internal control, the auditor relies upon the integrity of the client's organization unless circumstances are such as to arouse his suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In no sense is the independent certified public accountant an insurer or guarantor, nor do his training and experience qualify him to act as a general appraiser, valuer, or expert in materials. Obviously his functions do not include matters of law which require the judgment of an attorney.

Responsibilities in Connection with Registrations of Securities

The responsibility of the independent public accountant with respect to financial statements and other financial data used in registration statements and prospectuses filed with the Securities and Exchange Commission has been discussed in several opinions of the Commission and is the subject of a number of its rules. Specifically, he is responsible for the examination and review of those financial representations contained in registration statements and prospectuses as to which he undertakes to express an opinion. His responsibility relates not only to the propriety of what is set forth, but also to the inclusion of such information as is necessary to make the statements not misleading.

Section 11 of the Securities Act of 1933 as amended provides possible liability for false or misleading registration statements on the part of: "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;" (Section; 11(a)(4)).

However, this possible liability of the accountant may not exist when: "as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of, or extract from, a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be [**page 14**] stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert" (Section 11(b)(3)(B)).

Under the Securities Exchange Act of 1934, the independent public accountant's consent to the use of his name in annual reports filed with the Commission is not required. Nevertheless, the accountant has a responsibility for misleading statements.

The financial data which may appear in a registration statement or a prospectus in reliance upon the examination or review of the independent public accountant as an expert are of two general types: (1) the financial statements, usually consisting of balance sheets, statements of profit and loss and surplus, and supplementary schedules; and (2) other financial data such as earnings summaries, sales and earnings tables, historical financial information, etc.

With regard to the registrant's primary responsibility for the financial representations in registration statements and prospectuses the Securities and Exchange Commission has said:

"The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."*

and again (in requiring certification as to observance of auditing standards)

". . . accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them. . . ."

In view of the gravity of the responsibilities attaching to those whose opinions are relied upon in the registration and marketing of securities it is important that the language used in registration statements and prospectuses to identify financial representations contained therein should be clear in characterizing the independent public accountant's relationship to those representations.

A more detailed delineation of the views of the Commission and **[page 15]** illustrative wording for use in registration statements and prospectuses designed to avoid the imputation of responsibility not contemplated by the act or intended to be assumed, appears on pages 43 to 48 of the appendix.

REPORTS OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The concept that management is primarily responsible for the accuracy of the financial statements and that the independent auditor can only express his opinion on them is fundamental to an understanding of the content and wording of his report.

This report varies in form. Sometimes it includes particulars as to the scope of the work, procedures followed, details of important items in the financial statements, and other material of interest. Sometimes it is limited to a concise statement of the scope of the examination, and the independent auditor's opinion, based on such examination, as to the fairness of the financial statements it accompanies.

Whether the short or the longer form is used, the standards of reporting are the same. Briefly stated, they call for an expression as to whether the financial statements are presented in accordance with generally accepted principles of accounting and whether such principles have been consistently observed in the current period in relation to the preceding period; and the inclusion of all informative disclosures not made in the financial statements which are regarded as necessary.

To avoid uncertainties in the minds of users as to the reliance which may be placed on the financial statements accompanying an independent certified public accountant's report, the membership of the Institute went on record at the

* 4 SEC 721 (1939).

November, 1949, meeting as disapproving issuance of a report containing or relating to a client's financial statements without either an expression of opinion, or a disclaimer of opinion with an indication of the reason why no opinion is given. (See pages 18 to 20.)

Short-Form Report

The short form of report is customarily used in connection with financial statements intended for publication, is often included as part of a detailed report, and may be used alone wherever a more detailed report is not required.

It calls for a minimum content consisting of a representation as to the work performed, usually expressed in an opening or "scope" **[page 16]** paragraph, and an expression, usually in a closing or "opinion" paragraph, of the independent auditor's findings as to the financial statements examined.

The opinion should be based upon an examination whose scope conforms to generally accepted auditing standards and includes such procedures as are considered necessary in the circumstances. Auditing standards, as differentiated from auditing procedures, relate to the nature and extent of evidence to be obtained, and require that "generally recognized normal auditing procedures" be applied "with professional competence by properly trained persons." Where there are specific exceptions a qualified opinion may nevertheless be expressed, provided the exception is not of such importance as to negative an expression of opinion as to the fairness of the financial statements as a whole.

Because of the weight which the independent certified public accountant's opinion accompanying financial statements carries with the investing and lending public and the responsibilities he assumes in expressing it, the importance of a reasonable uniformity in the manner of stating the opinion, both to him and to those who rely on his findings, is apparent. Experience and discussion have evolved, and the profession in general has adopted, the following where the short form of accountant's report (sometimes described as a "certificate," an "opinion," a "report", or a "report and opinion") is used:

> "We have examined the balance sheet of X Company as of December 31, 19— and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> "In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

Although a review of the system of internal control and tests of its effective performance are an important part of the independent auditor's determination of the tests and procedures he considers necessary, specific reference to such review was omitted from the **[page 17]** recommended form since it was covered in the reference to generally accepted auditing standards. The statement that a detailed audit was not made of transactions, previously made in many certificates, was believed to be unnecessary in view of the emphasis placed in public and professional discussion, on the test character of independent audits and the understanding that detailed audits involve prohibitive auditing costs.

While this short-form report is not always appropriate verbatim, it is recommended that the substance of its phrases be used unless inappropriate in the particular case.

The report should be addressed to the client, or to the board of directors or the stockholders of the client if the appointment is made by them or if such address is preferred. Where the selection is made by the directors and approved by the stockholders the report may well be addressed to both.

Delineation of auditing procedures followed may be included where believed to be in the interest of clear disclosure of material fact, or where it is desired to comply with the client's request for amplification; explanations may be included, preferably in a separate paragraph, of essential matters which the client is unwilling to include in the financial statements; but where any such disclosures are made by reason of any reservation or desire to qualify the opinion they become exceptions and should be expressly stated or referred to as such in the opinion paragraph.

It is sometimes desirable that exceptions be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, a specific item in the financial statements, the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception. To the extent practicable, the effect of each such exception on the related financial statements should be given.

In all cases in which generally accepted auditing procedures are not carried out, or generally accepted auditing standards are not applied, unless the items are not material, disclosure is called for in the scope paragraph, together with either a specific qualification or a disclaimer of opinion, depending upon the relative importance of the items affected, in the opinion paragraph; except that in those rare cases in which the independent auditor has been able to satisfy him- **[page 18]** self by other methods, a disclosure in the scope paragraph is sufficient. (See pages 20 and 21.)

The matters which call for specific qualification of opinion or for a disclaimer of opinion are in the final analysis matters which rest upon the judgment of the independent auditor. He must decide whether, in the particular circumstances, the possibility of error is such that it could result in material misstatement. He should bear in mind that he has the burden of justifying any unqualified opinion, or any qualified opinion, that he expresses and that, to express an unqualified opinion, he must have reason to believe and must believe that the financial statements fairly present the financial position and results of operations and that they disclose all material facts necessary to make them not misleading. In judging the latter, he must bear in mind that a mere recital of facts is not always enough; disclosure implies adequate indication of the significance and effect of the facts upon the financial position and operating results.

Clarification of Report When Opinion Is Omitted

The presentation of financial statements on the stationery or in a report of an independent certified public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third

parties have no basis for determining what inferences are warranted by the association of his name with the financial statements and may place undue reliance upon them.

Illustrative of the practices which frequently give rise to such uncertainties are the following:

a. The presentation of financial statements on the stationery of the independent certified public accountant without comment, opinion or signature; or with the assertion that the statements are "for management purposes only."

b. The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an independent certified public accountant in which financial statements and comments on the scope of the audit are included.

In the first case it is not clear whether, by his silence, the accountant intends to express unequivocal satisfaction with the financial statements or whether he intends to disclaim any opinion at all. The assertion that the statements are "for management purposes only" leaves the reader in doubt as to whether it indicates a limita- [**page 19**] tion on the scope of the examination, whether it merely designates the form in which fully-approved statements are presented, or whether it has some other significance. In the second case his procedures are described but it is not clear whether or not those procedures were sufficient to permit the expression of an opinion.

Since the independent certified public accountant cannot effectively control the use to which financial statements accompanied by his name may be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously in the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession. Whenever, therefore, financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the character of the examination, if any, made by him in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When he is unable to express an over-all opinion, the reasons therefor should be stated. When he considers it appropriate to comment further regarding compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the fairness of the statements taken as a whole, he should be careful to indicate clearly the limitations of such comments to individual items in the financial statements.

The following formal statement reflecting these views was approved by the membership at the annual meeting of November 1949:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope that he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those

which require the denial of an opinion on the over-all fairness of the financial [**page 20**] statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

"Whenever the accountant permits his name to be associated with financial statements, he should determine whether in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit,* appearing prominently on each page of the financial statements is considered sufficient.

"It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

EXTENSIONS OF AUDITING PROCEDURES

At the 1939 annual meeting, the membership of the Institute approved the extension of auditing procedures to require observation of inventories and confirmation of receivables where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. These procedures were thus established as an integral part of generally accepted auditing procedures. Failure to apply them, where they are practicable and reasonable, in general [**page 21**] precludes expression of an opinion on the fairness of the financial statements taken as a whole.

The procedures, it will be noted, must be *both* practicable and reasonable. In the province of auditing, *practicable* means "capable of being done with the available means" or ". . . with reason or prudence"; *reasonable* means "sensible in the light of the surrounding circumstances." For example, the observation of physical inventories at the beginning of the period or year under examination would seldom, if ever, be practicable or reasonable in initial or "first" audits. However, the independent accountant must satisfy himself as to such inventories by appropriate methods.

It is believed that there are very few cases in which the additional procedures cannot be applied to inventories at the end of the period or year under examination to the extent that will permit such tests as the independent auditor, in the exercise of his judgment, determines to be reasonable.

In all cases in which the extended procedures are not carried out with respect to inventories or receivables at the end of the period or year, and they are a material factor, the independent certified public accountant should disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable and even though he may have satisfied himself by other methods.

In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph with respect to such omission. In deciding upon the "other procedures" to be employed he must bear in mind that he has the burden of justifying the opinion expressed.

Where the procedures are applicable but are not used and he has not satisfied himself by other procedures he should, if the amount is significant, disclaim an opinion on the fairness of the statements as a whole; except that where the amount with respect to which he is unable to satisfy himself is not sufficiently material to preclude an expression of opinion on the statements as a whole but is nevertheless important enough to deserve mention, he may make a specific exception in the opinion section of the report as to this amount.

The singling-out of these procedures for special consideration arose out of the great interest of the public and the profession in in- **[page 22]** ventories and receivables as determinants of financial position and earnings. The relative space given to them herein should not be taken to mean that they are the only important procedures or even necessarily the most important. In some cases other auditing procedures may outweigh them in significance.

Inventories

The extended procedures as to inventories are as follows:

Where the independent certified public accountant intends to report over his signature on financial statements in which inventories are a material factor, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In so doing he may require physical tests of inventories to be made under his observation.

Where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date before or after but reasonably close to that date, with adequate records supporting the changes during the intervening period), it is ordinarily necessary for the foregoing procedures to be followed at that time.

Where well kept and controlled perpetual inventory records are maintained, supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the related inventory record at least once in each year, it is satisfactory to undertake the procedures outlined at any interim date or dates selected by the

independent auditor, his purpose being to satisfy himself as to the credibility of the perpetual inventory records and the reliance that may be placed on them in supporting the inventory totals as shown in the balance-sheet.

In the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from the custodians is acceptable provided that where the amount involved represents a significant proportion of the current assets or of the total assets, supplemental inquiries are made to satisfy the independent auditor as to the bona fides of the situation.

[**page 23**] The independent auditor does not "take," "determine," or "supervise" the inventory. These operations are undertaken by management, antecedent to its primary representations concerning quantity, condition, and value. He observes and tests these procedures in his capacity as independent auditor, but he does not, and should not in his ordinary capacity as an independent auditor, make the original determination. He gives consideration to the effectiveness of the internal control as applied not only to the book records but also to the procedure of taking physical inventories. His functions do not include those of a general appraiser, valuer, or expert in materials.

Application of these procedures is greatly facilitated when concerns adopt their natural business year instead of the calendar year as their fiscal year, and use continuous, well-kept perpetual inventory records.

Inventories of Department Stores, Instalment Houses, Chain Stores, and Other Retailers

Notwithstanding the great variety and volume of merchandise comprehended in inventories of clients falling within the above categories, it is believed to be practicable and reasonable for the independent auditor to participate by suitable observation at the time inventories are determined by physical count by the client, or to require physical tests of inventories to be made under the independent auditor's observation. The method, extent, and time of applying these procedures necessarily will vary with the circumstances, and they will be undertaken in addition to the usual auditing tests and checks of the inventory accounts and records with due consideration of the effectiveness of the internal control, as applied not only to book records but also to the procedure of taking physical inventories.

Distinction should be made between large institutions with a great number of branches or departments and the more compact organizations, because volume of transactions requires more than ordinary division of duties, affording the opportunity for more effective internal control. In the larger organizations the observation or tests of physical inventories may well be limited to a relatively small number of branches or departments. The larger the number of branches or departments and the more effective the internal control, the smaller may be the percentage to be covered. In unusual cases quite a small percentage may well be proper.

While obviously no pattern of inventory observation can be de- [**page 24**] vised which will suit all situations, reference to the case studies appearing on pages 33 to 40 of the appendix will provide illustrative material of interest.

Inventories in Interim Financial Statements And the Independent Auditor's Report Thereon

An important problem which affects a considerable segment of the profession concerns the opinion, if any, which may properly be expressed in the

independent certified public accountant's report covering interim monthly financial statements in those situations where audits of the usual scope are made on either a semi-annual or an annual basis in accordance with generally accepted auditing standards, but where on other interim dates one or more procedures are omitted, such as, for example, the observation of inventories or the confirmation of receivables.

The major question presented concerns the procedures necessary, in addition to the audit of intervening transactions incident to the usual periodic interim examination and to the examination of the regular semi-annual or annual financial statements, in order that the independent auditor may be in a position to furnish an opinion as to the interim statements.

Where there are well-kept and controlled perpetual inventory records the observation of quantities may be undertaken at a date other than that of the balance sheet; or it may be staggered throughout the year if the client takes physical inventories of individual items from time to time so that the quantity of each item on hand is compared with the related perpetual inventory record at least once in each year. If this is done no exception as to the scope of the interim examination with respect to inventory quantities is necessary. However, where "well-kept and controlled perpetual inventory records" are not tied in with the inventory control accounts maintained in dollars, it is essential that they be so tied in as of the balance sheet date or some date reasonably close to it.

Need for exception as to the scope is also avoided where the regular inventory procedures are complied with at a date either before or after that of the interim financial statements, but within a reasonable time thereof in the light of the rapidity of turnover and adequacy of the records supporting the interim changes. Execution of the customary procedures at a date or dates other than that of the balance sheet with respect to these as well as other items, where ap- **[page 25]** propriate, should be encouraged as a means of spreading the work and reducing year-end pressure.

Where an opinion is to be expressed the standards of auditing procedure applicable to regular semi-annual and annual statements are likewise applicable to interim statements, not only as to inventories but as to other items in the financial statements such as securities, bank balances, liabilities, etc.; though with the closer contact and greater familiarity with the business which periodic interim examinations provide, it may be unnecessary to carry through the customary procedures in as complete detail at interim dates as at the year-end.

Receivables

The extended procedures as to receivables are as follows:

Where the independent certified public accountant intends to report over his signature on financial statements in which notes and accounts receivable are a significant factor, confirmation by direct communication with the debtors shall, where practicable and reasonable, be a part of generally accepted auditing procedures; the method, extent, and time of obtaining such confirmations in each engagement, and whether of all receivables or a part thereof, shall be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Methods of Confirmation—Positive and Negative

The *method* of confirming receivables in each engagement is among the matters left to the judgment of the independent certified public accountant.

Generally speaking, there are two types of confirmation requests—positive and negative. The positive form is a communication addressed to the debtor asking him to confirm to the independent auditor the accuracy of the balance shown, or state wherein it is inaccurate. The negative form is a communication addressed to the debtor asking him to reply only in case the amount stated is incorrect.

Where there is reason to believe that the possibility of disputes, inaccuracies, or irregularities in the accounts is greater than usual, or that the request will fail to receive consideration, or where the balance involved is of outstanding materiality, it is usually desirable that the positive method of confirmation be adopted. For example, **[page 26]** the positive method is used in requesting confirmation of receivables of stock brokerage houses. And where a substantial portion of a client's output is sold to one customer or to only a few customers so that the balances involved are of relatively major importance, the positive method seems clearly preferable.

On the other hand it is believed that, where there are no indications that it may be inadequate, use of the negative method conforms to generally accepted auditing standards in the majority of situations.

Not infrequently both methods are used in the same engagement—the positive as to accounts where a definite reply is regarded as desirable and the negative where this need does not exist.

When positive confirmations are sought it is usually impossible to secure responses to all requests; even in audits of stock brokerage houses, where the requests are usually followed up more actively than in the ordinary case, it is rare that replies are received to all the requests mailed.

The adequacy of response to requests for positive confirmation is usually judged by comparing the number of replies received and the total amount represented by them with the number and total amount of the accounts for which confirmations were requested, after taking into account the nature of the replies and the situations they disclose. The percentage of replies, experience has shown, varies considerably with the type of customer. The independent certified public accountant must assume the responsibility for deciding whether the nature and extent of response, taken in conjunction with his other auditing procedures, constitute a satisfactory basis for his opinion as to the bona fides of the receivables. This is a matter for the exercise of his judgment in each case. If he does not consider the confirmation results to be satisfactory he should pursue the matter further, either by communicating again with those who have not replied or by adopting alternative procedures of the nature described on page 28.

Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers

Question might justifiably be raised as to the reasonableness of applying the *positive* form of confirmation to receivables of department stores, instalment houses, chain stores, and other retailers, but it is believed that no question exists as to the practicability and reasonableness of using the *negative* confirmation form which re- **[page 27]** quires no reply unless the recipient challenges its showings. When dealing with housewives, as is the case in department stores particularly, the negative form is more practicable than the positive, as it does not require specific reply if the balance shown is correct, yet places the recipient definitely on notice that the independent auditor assumes the correctness of the balance unless the debtor objects within a reasonable time.

Distinction should be made between small institutions and those with receivables which may run into tens of thousands of items, because in the latter the very mass of the accounts requires more than ordinary division of duties, connoting usually more effective internal control. Confirmation of receivables by a selective test, where the conditions justify it, is within the contemplation of the prescribed procedures. The larger the mass, the smaller the average amount, and the more effective the internal control, the smaller, as a rule, may be the percentage of confirmation. In unusual cases quite a small percentage may well be proper.

Receivables in Interim Financial Statements And the Independent Auditor's Report Thereon

Interim statements present a problem for a considerable number of practitioners in connection with receivables—a problem as to what opinion, if any, may properly be expressed in the independent auditor's report covering interim monthly financial statements in those situations where audits of the usual scope are made on either a semi-annual or an annual basis in accordance with generally accepted auditing standards, but where on other interim dates the confirmation of receivables is omitted. As in the case of inventories, the question concerns the procedures necessary to enable the auditor to furnish an opinion with respect to the interim statements.

Frequently the conditions surrounding a particular engagement may be such as to warrant, or even make desirable, the staggering of the confirmation process throughout the semi-annual or annual period. If this is done in an acceptable manner and the results are satisfactory, necessity for exception as to the scope of the interim examination respecting confirmation of receivables is removed.

Where the regular procedures in connection with receivables are complied with at a date either before or after that of the interim financial statements, but within a time considered to be reasonable on the basis of rapidity of turnover and adequacy of the records supporting the interim changes, again the necessity for exception as **[page 28]** to the scope is eliminated. Execution of the procedures at a date or dates other than that of the balance sheet will have the incidental but valuable advantage of reducing year-end pressure.

Receivables from the United States Government

In view of the procurement conditions under which United States Government departments and agencies are sometimes required to operate they have at times expressed their inability to confirm amounts stated in requests for confirmation. The negative form of confirmation should not be used where the independent auditor has reason to believe that the request will fail to receive consideration and that he will not be notified if the amount stated in the request differs from the amount shown on the debtor's records.

In any case in which receivables from United States Government agencies or departments represent a significant proportion of the current assets or of the total assets of a concern and confirmation by direct communication with the debtors has not been accomplished, omission of the procedures should be disclosed in the general scope section of the report, and, depending upon the circumstances, may require specific qualification or denial of an opinion.

In many, and perhaps most, cases the independent auditor may be able, by reference to shipping records, contracts, correspondence, or other documentary evidence, or evidence of subsequent collection, to satisfy himself on a test basis

as to the validity of these receivables. In such cases his disclosure of inability to secure confirmation may well be accompanied by a statement that he has satisfied himself by other means. Both purposes may be accomplished by changing the sentence regarding conformity with generally accepted auditing standards contained in the report so that it will read somewhat as follows:

"Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances; however, it was not practicable to confirm receivables from United States Government departments (and agencies, if applicable), as to which we have satisfied ourselves by means of other auditing procedures."

It is obvious that in these circumstances no exception need be taken in the opinion section of the report.

There may be cases in which, due to the particular circumstances, the independent auditor may not be able to satisfy himself by other [**page 29**] methods as to such receivables. In those cases he must decide in the light of the circumstances whether the situation properly can be covered by taking a specific exception, as to the items involved, in the opinion paragraph; there may occasionally be situations in which the exception is of such a nature and so material in relation to the financial position and results of operations that he would be required to disclaim sufficient basis for the expression of an informed opinion regarding the financial statements as a whole.

CONCLUSION

As explained in the historical preface, this codification is not designed to serve as a compendium of audit procedures, since it deals only with such aspects of auditing as have from time to time, because of public interest or new developments, required special study or affirmation. It is intended to serve as a guide in certain of the many situations found in practice which call upon the independent certified public accountant for the exercise of judgment, and to supplement the material contained in other publications of the committee on auditing procedure and in the profession's considerable store of textbooks.

The case studies, comments on certain governmental regulations, and other reference material included in the appendix will, it is hoped, furnish further guidance.

Codification of Statements on Auditing Procedure

Committee on Auditing Procedure (1950-1951)

Alvin R. Jennings, *Chairman*	Malcolm Lamont
Donald J. Bevis	J. Woodrow Mathews
Garrett T. Burns	Ira B. McGladrey
Charles F. Coates	Benjamin Neuwirth
M. C. Conick	Fred G. Page
Carl M. Esenoff	Oliver W. Seifert
Walter R. Flack	Ralph L. Stauffer
Harry C. Grumpelt	A. Frank Stewart
Russell C. Harrington	Cyril Talbot
Gordon M. Hill	Charles H. Towns

Carman G. Blough, *Director of Research*

Annual Reports to Employees

(Continued from page 102)

In elaborateness the reports range from a two-page folder to Esso's thirty-two page, many-color booklet. There are as many variations in reports as there are in budgets and report directors. This situation will probably continue as long as there seems to be no responsibility to present financial data to employees in accordance with some of the "generally accepted standards" applicable to reports to stockholders.

MEMBERS' REQUESTS FOR COMMITTEE APPOINTMENTS

The Advisory Committee on Appointments, which is charged with the responsibility of recommending personnel for each of the Society's committees to the incoming President, is seeking members' requests or recommendations for committee appointments. All members have received a letter from Mr. J. B. C. Woods, Chairman of the Committee, requesting those who desire to serve the Society through the committees to indicate their interests and qualifications. Those who wish to serve or are in the position to recommend members for committee work are urged to respond immediately to this request if they have not as yet done so.

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Change of Classification

To be subject to tax as a real-estate company, the corporation must be *wholly* engaged in the permissive real-estate activities. Some leeway is permitted for non-real-estate activities.

> ". . . a corporation shall be deemed to be wholly engaged in such activities if, during the preceding year, not more than ten per centum of its average gross assets, at full value, consisted of stocks, bonds or other securities or loans to wholly owned subsidiaries taxable under this section." (Sec. 182[1])

When does the change of classification become effective? Article 160 of the Regulations under Article 9A states that if more than 10% of the average gross assets is invested during any year in securities the real-estate corporation becomes subject to tax under Article 9A on the first day of the following year. For example, suppose a corporation owned two parcels of real property valued at $25,000 and $10,000, respectively. On April 1, 1950, it sold the first parcel for $25,000, and invested the proceeds in securities. Since more than 10% of the average gross assets for the year consisted of securities, the corporation became subject to tax under Article 9A on January 1, 1951. (Art. 160, Example 4.)

Suppose the corporation sold the securities on January 2, 1951, for $25,000. As a result, less than 10% of the average gross assets for the year was invested in securities. According to the Regulations the corporation again became subject to tax under Section 182, but not until the first day of the following year, namely January 1, 1952.

The effect of the regulation is to exact a penalty for having transgressed the 10% requirement. For almost a year the corporation qualifies as a real estate corporation, but it must still pay a tax as a business corporation. The Tax Commission argues that it cannot be known until the last day of the year whether more than 10% of the average gross assets, "during the *preceding* year" has been invested in securities and, therefore, a change in classification cannot be made until the first day of the following year. The law itself does not require such a holding. It would be consistent with the law to tax the corporation again as a real-estate company from the date it again qualifies as such. This would be eminently fair, since a corporation that inadvertently invests in securities to the extent of more than 10% of average gross assets can purge itself of a technical transgression of the law and thus be property classified. The law itself seems to provide that a *change of classification* occurs on the first day of the following year. But the law makes no specific provision for a re-change in classification. That is something that the Regulations appear to have added to the law.

Benjamin Harrow, C.P.A., has been a member of our Society since 1928, and a member of the American Institute of Accountants since 1922. He is a member of the New York Bar and Professor of Law at St. John's University.

Mr. Harrow is a past Vice-President of the Society. He is a past Chairman of the Committee on Publications and of the Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Business Capital

This is defined generally as all assets less liabilities. However the franchise tax law is realistic. It recognizes the fact that a business may finance itself through borrowed capital as well as equity capital. Hence in determining business capital (the basis for the one mill tax), only short-term loans are considered true liabilities. These are stated in the law to be liabilities payable by their terms on demand or within one year from the date incurred. In 1948, a restriction was added to the deductible liabilities. Loans or advances outstanding for more than a year as of any date during the year are treated as borrowed capital.

The Regulations (Art. 332) add something not in the law. Notes payable by their terms for not more than one year from date, *which are regularly renewed from year to year* are not deductible in computing business capital. This raises an interesting question.

Suppose a taxpayer regularly borrows money from a bank or several banks on a three-months basis. Notes may be renewed or partly paid. A note may be paid in full and money borrowed from a different bank. Suppose further that within credit limitations a certain minimum amount is always outstanding. Would such liabilities be considered as true liabilities or would the minimum amount be treated as borrowed capital and be deducted from the liabilities in arriving at the tax based upon capital?

The intention of the tax advisory group that recommended the revision of the franchise tax law in 1945 was to include in the concept of capital, borrowed capital such as long-term bonds. Bank accommodations were not intended to be considered as capital unless the loan was a long-term obligation, due in more than one year. A loan that must be paid within three months is by every definition a short-term obligation. The renewal of such an obligation does not convert it into a long-term obligation even though successive renewals may have the same overall effect as an indebtedness outstanding for more than a year. By its terms, a three-months obligation must be met at maturity, either by payment in full, part payment or renewal. A renewal depends upon the credit factors present at the time of renewal. There is no assurance that a note will be renewed when due and, in fact, banks expect a depositor to be free from debt for some interval at least once a year.

The long-term obligation, one at least for a period of a year, is a radically different obligation. Here, by its terms, borrowed money will be at the disposal of a business for a long enough time to be considered capital. To call a short-term obligation long-term because of frequent renewals is to freeze a minimum indebtedness into a concept of capital. In one sense all credit extended to a taxpayer has the effect of capital being employed in a business. All the average indebtedness for the year may in this sense be said to be borrowed capital. But that is a far cry from calling such obligations long-term obligations. If the Tax Commission wants to tax short-term obligations as capital because renewals may be said to convert short-term obligations into long-term ones, then the Legislature should be asked to change the law. It is not presently in the law and if the regulation appears to give some sanction to such a procedure, then the Tax Commission is exceeding its authority.

Change of Residence

A resident of the state is taxable on his income from all sources. A person domiciled in the state is deemed to be a resident, but if he does not maintain a permanent home in New York and does maintain such a home outside the state he will not be taxed as a resident,

provided he does not spend an aggregate of thirty days within the state.

Even if a person is not domiciled in the state he may be taxed as a resident for the entire year if he maintains a permanent home within the state and spends in the aggregate more than 183 days[1] of the year within the state.

A non-resident is taxed on his income only from New York sources. The law also provides that if a taxpayer changes his status from that of a resident to a non-resident, or the reverse, he must file two returns, a resident return and a non-resident return for the respective periods of residency and non-residency.

There would appear to be a conflict between the 183-day rule (Sec. 350.7) and the change-of-status rule in Sec. 367(a). For example, on August 1 a person domiciled in New York changes his domicile to Colorado. He had resided at a permanent home in New York until he left the state for Colorado. Is he taxable on all of his income from all sources for the entire year or only until August 1st, and thereafter taxable on income only from New York sources? In our opinion, if the Tax Commission is satisfied that there has been a bona fide change of domicile, the individual would be taxed partly as a resident and partly as a non-resident in spite of the 183-day rule. The same rule would probably apply in the case of a non-resident who becomes a resident during the year and thereafter spends 183 days in the State. The 183-day rule is intended to apply to persons who are domiciled in another state, but have an apartment or home in New York. Such a person may also have a home in the domiciliary state. Usually the domiciliary state has no income tax law and the real home life of such a person is centered in New York. If such a person spends 183 days in New York, the state feels that it may call him a resident and tax him, the same as any bona fide resident, on all of his income from all sources for the entire year. There has been no formal ruling on this conflict between the 183-day rule and the change-of-status rule.

[1] This was formerly the 7-months rule, which was changed to 183 days by Ch. 99, Laws of 1954.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Under the Securities Act of 1933 the SEC is authorized to exempt from the registration requirements of the Act certain small offerings, that is, where the aggregate amount of the offering does not exceed $300,000. Under this authority the Commission promulgated Regulation A which provides a general exemption from the registration requirements for certain securities of United States companies. Regulation D contains similar exemptions for certain Canadian securities.

In July, 1955, the SEC announced that it proposed to revise and consolidate Regulations A and D. The revision, if adopted, would result in a single integrated exemptive regulation for both United States and Canadian securities.

One of the principal features of the revised regulation would be the following special requirements which would apply only to promotional companies:

a. The securities to be offered would have to be qualified for sale in the State or Province in which the issuer has its principal business operations, and offered for sale in such State or Province concurrently with the offering in other jurisdictions.

b. No securities could be offered except for the account of the issuer; secondary offerings, "bail-outs", and offerings of underwriters' shares or options, would not be permitted under the exemption.

c. Provision would have to be made, by escrow or otherwise, to assure the return to subscribers of the money paid in unless at least 85% of the total offering is sold and paid for within six months after the commencement of the offering.

d. In computing the amount of securities which could be offered under the new regulation, there would have to be included the amount of all securities issued or proposed to be issued, for assets or services or to directors, officers, promoters, underwriters, dealers or security salesmen, and held by them, except to the extent that such securities are escrowed or otherwise effectively held off the market for a period of one year after the commencement of the offering under the new regulation.

e. No sales literature, other than the prescribed offering circular and limited advertisements specificially permitted by the rules, could be used in connection with the offering of securities of promotional companies.

The new regulation would continue the requirement for the filing of a "notification" and for the filing and use of an offering circular where the proposed offering is in excess of $50,000.

The SEC has recently announced a further revision in the proposed regulation. The further amendment now proposed would provide that the financial statements required to be contained in offering circulars be certified by independent public or independent certified public accountants. The proposed amendment would also require that the certifying accountant consent to the use of his name and certificate.

The Commission's release announcing this further amendment states the proposal as follows:

> It is contemplated that if the issuer is a commercial, industrial or extractive company in the promotional, exploratory or development stage, all of the required statements shall be certified. If the issuer does not fall in this category, the financial statements shall be certified, provided that if interim-period statements are necessary to come within the 90-day time limit, these need not be certified if a certified balance sheet or statement of financial condition at the close of the most recent fiscal year is furnished together with certified statements of profit and loss and surplus for the fiscal years to the date of the certified balance sheet or statement of financial condition.

Persons who are interested in the proposal are invited to submit their views and comments on or before February 17, 1956.

Louis H. Rappaport, C.P.A., is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Management Services by CPAs

The rendering of services other than the traditional examination of records and preparation of statements raises the question, from time to time, of their professional propriety and desirability. Recently, correspondence on this subject was made available to the editor of this column by virtue of his membership on a committee of the American Institute of Accountants dealing with management services by CPAs. The subject was dealt with in a forceful and conclusive manner. Widespread circulation of this portion of the correspondence in accounting circles is well warranted and it is here submitted:

Question:

"How would you define the proper and desirable bounds of the scope of professional accounting practice with reference to such criteria as:

(a) maintaining the CPA's independence

(b) the danger of spreading his efforts too thin

(c) staying within his professional field?

"For example, I suppose that areas which might be near the limits of propriety or of sound policy are (a) advocacy in tax and other controversies, (b) advice on business policy, (c) supervision of bookkeeping, (d) industrial engineering, and (e) investment advice."

MAX BLOCK, C.P.A. (N. Y., Pa.) is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Answer by Clifford Heimbucher, C.P.A. (Cal.):

"You ask first for a definition of the proper and desirable bounds of professional accounting practice. In my opinion a professional accounting practice comprises the offering of and the performance of services to the business community involving primarily the making of independent examinations of financial statements but which may also properly include any type of professional management advice or assistance. Any such management services offered must be professional in character, which means that the following attributes are assumed to be present:

"(a) the particular accountant involved is qualified by aptitude, education, and training to perform the specific services offered.

(b) the services are performed as an independent contractor and not as an employee in the usual sense.

(c) the services are dignified in nature, and are such as would be presumed to require at least a reasonable degree of education and training.

(d) the services are legally and ethically proper.

(e) to the extent that the services involve expressions of opinion which may be relied upon by third parties the accountant is in fact fully independent or such third parties are fully informed as to any facts which might lead them to question his independence.

"You ask further that this definition be related to three criteria in particular, of which the first is the maintenance of

the CPA's independence. In my opinion independence is fundamentally a state of mind, rather than adherence to a set of predetermined rules. The true tests of independence are basically subjective in nature and include such factors as the CPA's desire to retain the particular client involved, the consequences to him of losing the client (monetary, prestige, self-esteem), his personal liking for the client, his feelings toward the third party involved, and other similar attitudes. I realize that this means that the CPA is, in effect, the principal judge of his own independence. I believe that this is fundamentally true and always has been. If the CPA has the intellectual aptitude and the proper education and training, I believe that he is capable of judging his own independence. Bear in mind that I refer here only to his judging his own independence from the standpoint of the propriety of his performing management services as well as auditing services for the same client. If the nature and extent of the management services are such that the opinions of third parties as to his independence might be affected then adequate disclosure should be made.

"Although I doubt that an objective set of criteria can be devised which would be fully adequate in guaranteeing independence and at the same time be realistic and workable, nevertheless it is clearly proper for third parties involved to set up their own sets of criteria to aid them in reaching a decision as to the extent to which they are willing to rely on the CPA's opinion. The most notable example of this is, of course, the set of rules of the SEC relating to independence.

"You also ask that particular reference be made to the danger of the CPA's spreading his efforts too thin and of going outside of his professional field. The fact that these dangers may be present does not, to my mind, warrant restricting the profession. They are almost always present in any professional field. I do not believe that any CPA can be really qualified to serve in every possible management advisory capacity. Therefore he must be careful to restrict his own services to those fields in which he is qualified. If he does this I do not see how he would be spreading his services too thin. The question of staying within his professional field is again one of judgment, involving such matters as the dignity of his services, the legality of his actions, and the general effects on his professional and social standing in the community.

"You cite four types of services which you indicate might be near the limits of propriety. The matter of independence, of course, runs through all of these, but I shall not comment further on that as I have already covered that subject. Another factor involved is the question of the propriety of advocacy in controversies. Whenever a controversy is known to all parties involved to exist and the CPA is not the judge who will decide the issue then there appears to be no reason why the CPA should not be an advocate. The parties are all aware of his position and are free to obtain opposing advocates. Obviously he must maintain the highest honesty and integrity, but this is not incompatible with being an advocate.

"Another factor which runs through the four examples cited is that of competence, which brings us back again to the question of judgment. For example, in connection with the matter of investment advice I believe a CPA is qualified to give investment advice as it relates to questions of evaluat[illegible] or buying or selling an operating business or forming or liquidating a subsidiary and similar matters. Often the CPA is the best qualified person in such cases. On the other hand, if a CPA is asked to act as a general investment advisor that is another matter. Personally I do not know any CPA

(Continued on page 132)

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance

An additional supply of the new 16-page brochure, "Questions and Answers about Unemployment Insurance Law Changes" has been made available for members of the Society and their staffs who have not as yet obtained copies. You may write for the number of copies you require to:

Samuel S. Ress,
Payroll Tax Notes Editor,
NYCPA
2488 Grand Concourse, Room 204A
New York 58, New York

If you do not receive your copies within one week, send in a follow-up letter.

Pending Legislation Before the New York Legislature

A series of bills that would have a profound effect on our unemployment insurance system have been presented for enactment by the Legislature and have been referred to the Labor Committee in the Assembly for report. These bills relate to:

Employer Reports of Employment and Wage Information on Form LO 12: Under the present law an employer must report employment information relating to any individual within seven days after he is requested to do so by the Industrial Commissioner. The employer must pay $10 for every request with which he failed to comply, unless he satisfies the Commissioner that his noncompliance was attributable to circumstances beyond his control.

The proposed amendment to the law would extend the time within which an employer must report to 15 days, and would make the penalty apply only if the noncompliance was willful.

Basis of Eligibility: A claimant now is required to have worked in covered employment for at least 20 weeks during the 52 weeks preceding the filing of his claim, as one of the qualifications in order to be eligible for unemployment insurance benefits.

The proposed amendment would reduce the requirement from 20 to 15 weeks.

Benefits' Rates and Duration: Under the present law the maximum rate of weekly benefits for unemployment insurance is $36 for 26 weeks a year.

The proposed measure would increase the maximum weekly rate to $45 for 36 weeks. In addition to benefits now payable to unemployed individuals, dependency benefits of $4 for each of a claimant's dependents would be paid, up to a maximum of 3 dependents. A dependent would be defined as a claimant's spouse not regularly engaged in any occupation for profit, a parent deriving regular support from the claimant, or the claimant's unmarried child under the age of 18 or over the age of 18 if totally disabled.

Benefit Rights in an Industrial Controversy: The law at present imposes a 7-week suspension on a claimant who

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becomes unemployed because of a strike, lockout, or other industrial controversy.

A bill would reduce the suspension period to 5 weeks. In addition, the bill provides that there would be no suspension at all if the claimant is not directly participating in the labor dispute, and if the dispute arises out of a lockout.

Voluntary Leaving and Loss of Employment Due to Misconduct: At present a claimant who left his employment voluntarily and without good cause is disqualified from receiving benefits for a period of 6 weeks. The amendment would reduce the period to 5 weeks.

Loss of employment due to misconduct results in a 7-week suspension of benefits. The proposed amendment would vary the suspension period from one to seven weeks depending upon the nature and severity of misconduct.

Cases of Refusal of Employment: At present a claimant who, without good cause, refuses to accept an offer of employment for which he is reasonably fitted by training and experience is disqualified from receiving benefits until after he has secured bona fide employment to demonstrate his attachment to the labor market, and then unemployed without disqualifying conditions.

The proposed amendment provides that the claimant could not receive benefits or serve a waiting period until five weeks after refusing an offer of employment without good cause.

Waiting Period and Loss of Benefits for False Statements: At present a claimant is not entitled to unemployment insurance benefits until after he has served a waiting period of four effective days at the commencement of his benefit year. This period is the equivalent of a full week of unemployment which may be accumulated in different benefit weeks in which the claimant was employed on some days and unemployed on other days during the week.

The proposed measure would eliminate the normal waiting period, so that the claimant would receive benefits beginning with his first week of unemployment.

The present law provides that a claimant must forfeit from 5 to 20 weeks of benefits if he has wilfully made a false statement or representation to obtain any benefit. This penalty may be imposed for each false statement or representation.

The proposed amendment would require the state to show that the false representation was both wilful and intentional in order to impose the penalty of loss of benefits on the claimant.

Extension of Coverage To Employers of One or More and Farmers: Another bill would extend compulsory coverage to employers of one or more employees, and discontinue the present exemption for agricultural employees. The present law covers employers of 3 or more on any day after December 31, 1955, and employers of 2 or more on any day after December 31, 1956, with domestics being considered separately from the employer's other employees; compulsory coverage is required for domestic servants if four or more are employed on any day after December 31, 1955.

Repeal of the Hughes-Brees "Merit Rating" Law Proposed: This law which was enacted in 1951, and provided for tax reductions under the Unemployment Insurance Law for employers who have stable employment records, would be repealed by a proposed amendment.

* * *

It must again be emphasized that the foregoing proposed bills have not as been enacted into law; they are still pending before the Legislature.

Role of the Accountant in Unemployment Insurance

Accountants should display more interest in unemployment insurance than

has been indicated heretofore. At the Spring technical meeting to be conducted by the Society's Committee on New York State Taxation, the disposition of the aforesaid proposed amendments and other changes in the New York State Unemployment Insurance Law will be reported to the membership.

Almost $300,000,000 a year is paid by New York employers for unemployment insurance contributions. The tax rates are not uniform for all employers, with the present range of rates running from .5% to 2.7% of taxable payroll. The rate any employer is assigned depends upon his experience under the law. Each covered employer has a separate bookkeeping account with the state Unemployment Insurance Accounts Bureau, credits being made for tax contributions paid by the employer, and charges against it for benefits paid to former employees. The balance in this account as of July 1 of any year is one of the most important factors in determining the employer's tax rate for the following year.

Accountants should establish controls for this account, and audit it just as they should any other account in the balance sheet or the operating statement of the client.

Wage and Hour Law—One Dollar an Hour Minimum Rate in Effect March 1, 1956

Accountants are reminded that commencing March 1, 1956, the Federal Wage and Hour Law requires covered employers to pay the new minimum wage rate of $1.00 an hour. Accountants should review employers' wage and hour rates and overtime-payment plans prior to this date, to be sure that they do not conflict with this new provision of the law, inasmuch as the wage and hour plan may have been based upon the former 75¢ an hour minimum wage rate.

Ford Supplemental Unemployment Benefit Plan Commences Operations

The Wage and Hour Administrator has ruled that the payments of five cents an hour for each employee employed since June 6, 1955, by the Ford Motor Company scheduled to begin on January 30, 1956, into trust funds for its supplemental benefit plan, sometimes described as a guaranteed annual wage plan, need not be considered in the computation of regular rates under the Fair Labor Standards Act or of basic rates under the Walsh-Healey Act for the purposes of determining an employee's overtime compensation.

The United States Treasury Department has ruled that the payments made by the company may be treated currently as deductible business expenses for federal income tax purposes.

Both the Industrial Commissioner and the Attorney-General of the State of New York have ruled that benefits received by laid off Ford employees from the Supplemental Benefit Fund which will commence paying benefits June 1, 1956, will not interfere with regular receipt by claimants of New York State Unemployment Insurance benefits. The amounts paid into the Supplemental Benefit Fund will not be taxable for New York State Unemployment Insurance purposes, unless these payments should be ruled taxable for Federal Unemployment Tax reasons.

New York State Wage and Hour Law—Proposed Changes

At present State minimum wage orders are in effect for ten industries: laundry, dry cleaning, beauty service, confectionery, hotel, restaurant, retail trade, amusement, building service, and counselor staff occupations in children's camps. The orders were promulgated by the Industrial Commissioner after receiving the recommendations of

wage boards composed of public, labor, and management representatives. The orders were issued under the provisions of the Minimum Wage Law, which authorizes the establishment of minimum wage standards for women and minors. Men are covered by the 10 minimum wage orders by virtue of the "supplementary protection" provision of the law, which states that in order to protect the standards for women and minors, no man shall be employed in an occupation at wage standards less than those fixed in a minimum wage order for women and minors. The basic minimum hourly rates fixed in the ten orders range from 65 cents to 80 cents.

A bill presented to the current legislature would establish a flat minimum rate for all workers in the state, with certain exceptions. All employees, except domestic and farm workers, would be covered. The minimum of $1.25 an hour would be fixed with provision for no less than 75 cents an hour for licensed handicapped persons. Existing wage orders would provide a basic $1.25 hourly rate. The overtime rate of pay would be time and one-half of regular rate of pay for work over 40 hours a week. *Executives and professionals earning over $100 a week may be excluded from the overtime provisions by regulations of the Industrial Commissioner.* Employees called for work on any day would have to be paid for at least 4 hours work at the applicable minimum rate.

There are other provisions for a nine-member Wage and Hour Advisory Council, and special tripartite special committees for various industries and occupations, with power to recommend higher minimum rates of pay. A Wage and Hour Law Appeals Panel would be established. If enacted the bill will go into effect June 1, 1956; it was introduced by Assemblyman Preller, as Assembly Introductory number 194, Print number 194.

Office and Staff Management

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who is fully qualified to act as such. However, if one does exist I do not see why he should be prohibited from using his abilities for the good of the business community.

"It has always been difficult for us to understand those who maintain, on the one hand, that a CPA is a member of a learned profession comparable t law, medicine, and education, and then hold, on the other hand, that he is incapable of sound subjective judgment and must therefore restrict his activities to narrow predetermined fields."

ACCOUNTING RESEARCH BULLETINS
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No. 45

Long-term Construction-type Contracts

1. This bulletin is directed to the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. It does not deal with cost-plus-fixed-fee contracts, which are discussed in Chapter 11, Section A, of Accounting Research Bulletin No. 43*, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, the bulletin would also be applicable in appropriate cases to the manufacturing or building or special items on a contract basis in a contractor's own plant. The problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

2. Considerations other than those acceptable as a basis for the recognition of income frequently enter into the determination of the timing and amounts of interim billings on construction-type contracts. For this reason, income to be recognized on such contracts at the various stages of performance ordinarily should not be measured by interim billings.

GENERALLY ACCEPTED METHODS

3. Two accounting methods commonly followed by contractors are the percentage-of-completion method and the completed-contract method.

Percentage-of-completion Method

4. The percentage-of-completion method recognizes income as work on a contract progresses. The committee recommends that the recognized income be that percentage of estimated total income, either:

(a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

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* *Restatement and Revision of Accounting Research Bulletins,* American Institute of Accountants, 1953.

5. Under this method current assets may include costs and recognized income not yet billed, with respect to certain contracts; and liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

6. When the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

7. The principal advantages of the percentage-of-completion method are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimates of costs to complete or of progress toward completion.

8. The principal disadvantage of the percentage-of-completion method is that it is necessarily dependent upon estimates of ultimate costs and consequently of currently accruing income, which are subject to the uncertainties frequently inherent in long-term contracts.

Completed-contract Method

9. The completed-contract method recognizes income only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provisions for losses. A contract may be regarded as substantially completed if remaining costs are not significant in amount.

10. When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

11. Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

12. When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown

among the liabilities, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs. It is suggested that the asset item be described as "costs of uncompleted contracts in excess of related billings" rather than as "inventory" or "work in process," and that the item on the liability side be described as "billings on uncompleted contracts in excess of related costs."

13. The principal advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses.

14. The principal disadvantage of the completed-contract method is that it does not reflect current performance when the period of any contract extends into more than one accounting period and under such circumstances it may result in irregular recognition of income.

Selection of Method

15. The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Disclosure of the method followed should be made.

COMMITMENTS

16. In special cases disclosures of extraordinary commitments may be required, but generally commitments to complete contracts in process are in the ordinary course of a contractor's business and are not required to be disclosed in a statement of financial position. They partake of the nature of a contractor's business, and generally do not represent a prospective drain on his cash resources since they will be financed by current billings.

The statement entitled "Long-term Construction-type Contracts" was adopted unanimously by the twenty-one members of the committee, of whom two, Mr. Coleman and Mr. Dixon, assented with qualification.

Mr. Coleman and Mr. Dixon do not approve the statements in paragraphs 6 and 11 as to provisions for expected losses on contracts. They believe that such provisions should be made in the form of footnote disclosure or as a reservation of retained earnings, rather than by a charge against the revenues of the current period.

Mr. Coleman also questions the usefulness of the refinement of segregating the offset costs and billings by character of excess as set forth in the second sentence of paragraph 12. He suggests that a more useful alternative would be to show in any event total costs and total billings on all uncompleted contracts (a) with the excess shown either as a current asset or a current liability, and (b) with a supporting schedule indicating individual contract costs, billings, and explanatory comment.

NOTES

(See Introduction to *Accounting Research Bulletin* No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

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